been approved, the bank shall implement the capital restoration plan as approved prior to the proposed amendment.

- (h) Performance guarantee by companies that control a bank—(1) Limitation on liability—(i) Amount limitation. The aggregate liability under the guarantee provided under section 38 and this subpart for all companies that control a specific bank that is required to submit a capital restoration plan under this subpart shall be limited to the lesser of:
- (A) An amount equal to 5.0 percent of the bank's total assets at the time the bank was notified or deemed to have notice that the bank was undercapitalized; or
- (B) The amount necessary to restore the relevant capital measures of the bank to the levels required for the bank to be classified as adequately capitalized, as those capital measures and levels are defined at the time that the bank initially fails to comply with a capital restoration plan under this subpart.
- (ii) Limit on duration. The guarantee and limit of liability under section 38 and this subpart shall expire after the FDIC notifies the bank that it has remained adequately capitalized for each of four consecutive calendar quarters. The expiration or fulfillment by a company of a guarantee of a capital restoration plan shall not limit the liability of the company under any guarantee required or provided in connection with any capital restoration plan filed by the same bank after expiration of the first guarantee.
- (iii) Collection on guarantee. Each company that controls a given bank shall be jointly and severally liable for the guarantee for such bank as required under section 38 and this subpart, and the FDIC may require and collect payment of the full amount of that guarantee from any or all of the companies issuing the guarantee.
- (2) Failure to provide guarantee. In the event that a bank that is controlled by any company submits a capital restoration plan that does not contain the guarantee required under section 38(e)(2) of the FDI Act, the bank shall, upon submission of the plan, be subject to the provisions of section 38 and this

subpart that are applicable to banks that have not submitted an acceptable capital restoration plan.

(3) Failure to perform guarantee. Failure by any company that controls a bank to perform fully its guarantee of any capital plan shall constitute a material failure to implement the plan for purposes of section 38(f) of the FDI Act. Upon such failure, the bank shall be subject to the provisions of section 38 and this subpart that are applicable to banks that have failed in a material respect to implement a capital restoration plan.

§ 325.105 Mandatory and discretionary supervisory actions under section 38.

- (a) Mandatory supervisory actions—(1) Provisions applicable to all banks. All banks are subject to the restrictions contained in section 38(d) of the FDI Act on payment of capital distributions and management fees.
- (2) Provisions applicable to undercapitalized, significantly undercapitalized, and critically undercapitalized banks. Immediately upon receiving notice or being deemed to have notice, as provided in §325.102 of this subpart, that the bank is undercapitalized, significantly undercapitalized, or critically undercapitalized, the bank shall become subject to the provisions of section 38 of the FDI Act:
- (i) Restricting payment of capital distributions and management fees (section 38(d));
- (ii) Requiring that the FDIC monitor the condition of the bank (section 38(e)(1));
- (iii) Requiring submission of a capital restoration plan within the schedule established in this subpart (section 38(e)(2));
- (iv) Restricting the growth of the bank's assets (section 38(e)(3)); and
- (v) Requiring prior approval of certain expansion proposals (section 38(e)(4)).
- (3) Additional provisions applicable to significantly undercapitalized, and critically undercapitalized banks. In addition to the provisions of section 38 of the FDI Act described in paragraph (a)(2) of

this section, immediately upon receiving notice or being deemed to have notice, as provided in §325.102 of this subpart, that the bank is significantly undercapitalized, or critically undercapitalized, or that the bank is subject to the provisions applicable to institutions that are significantly undercapitalized because the bank failed to submit or implement in any material respect an acceptable capital restoration plan, the bank shall become subject to the provisions of section 38 of the FDI Act that restrict compensation paid to senior executive officers of the institution (section 38(f)(4)).

- (4) Additional provisions applicable to critically undercapitalized institutions. (1) In addition to the provisions of section 38 of the FDI Act described in paragraphs (a)(2) and (a)(3) of this section, immediately upon receiving notice or being deemed to have notice, as provided in §325.102 of this subpart, that the insured depository institution is critically undercapitalized, the institution is prohibited from doing any of the following without the FDIC's prior written approval:
- (A) Entering into any material transaction other than in the usual course of business, including any investment, expansion, acquisition, sale of assets, or other similar action with respect to which the depository institution is required to provide notice to the appropriate Federal banking agency;
- (B) Extending credit for any highly leveraged transaction;
- (C) Amending the institution's charter or bylaws, except to the extent necessary to carry out any other requirement of any law, regulation, or order;
- (D) Making any material change in accounting methods;
- (E) Engaging in any covered transaction (as defined in section 23A(b) of the Federal Reserve Act (12 U.S.C. 371c(b));
- (F) Paying excessive compensation or bonuses:
- (G) Paying interest on new or renewed liabilities at a rate that would increase the institution's weighted average cost of funds to a level significantly exceeding the prevailing rates of interest on insured deposits in the institution's normal market areas; and

- (H) Making any principal or interest payment on subordinated debt beginning 60 days after becoming critically undercapitalized except that this restriction shall not apply, until July 15, 1996, with respect to any subordinated debt outstanding on July 15, 1991, and not extended or otherwise renegotiated after July 15, 1991.
- (ii) In addition, the FDIC may further restrict the activities of any critically undercapitalized institution to carry out the purposes of section 38 of the FDI Act.
- (5) Exception for certain savings associations. The restrictions in paragraph (a)(4) of this section shall not apply, before July 1, 1994, to any insured savings association if:
- (i) The savings association had submitted a plan meeting the requirements of section 5(t)(6)(A)(ii) of the Home Owners' Loan Act (12 U.S.C. 1464(t)(6)(A)(ii)) prior to December 19, 1991;
- (ii) The Director of OTS had accepted the plan prior to December 19, 1991; and
- (iii) The savings association remains in compliance with the plan or is operating under a written agreement with the appropriate federal banking agency.
- (b) Discretionary supervisory actions. In taking any action under section 38 that is within the FDIC's discretion to take in connection with:
- (1) An insured depository institution that is deemed to be undercapitalized, significantly undercapitalized, or critically undercapitalized, or has been reclassified as undercapitalized, or significantly undercapitalized: or
- (2) An officer or director of such institution, the FDIC shall follow the procedures for issuing directives under §§ 308.201 and 308.203 of this chapter, unless otherwise provided in section 38 or this subpart.

APPENDIX A TO PART 325—STATEMENT OF POLICY ON RISK-BASED CAPITAL

Capital adequacy is one of the critical factors that the FDIC is required to analyze when taking action on various types of applications and when conducting supervisory activities related to the safety and soundness of individual banks and the banking system. In view of this, the FDIC's Board of Directors has adopted part 325 of its regulations, which sets forth (1) minimum standards of

capital adequacy for insured state nonmember banks and (2) standards for determining when an insured bank is in an unsafe or unsound condition by reason of the amount of its capital.

This capital maintenance regulation was designed to establish, in conjunction with other Federal bank regulatory agencies, uniform capital standards for all federally-regulated banking organizations, regardless of size The uniform capital standards were based on ratios of capital to total assets. While those leverage ratios have served as a useful tool for assessing capital adequacy, the FDIC believes there is a need for a capital measure that is more explicitly and systematically sensitive to the risk profiles of individual banks. As a result, the FDIC's Board of Directors has adopted this Statement of Policy on Risk-Based Capital to supplement the part 325 regulation. This statement of policy does not replace or eliminate the existing part 325 capital-to-total assets leverage ratios.

The framework set forth in this statement of policy consists of (1) a definition of capital for risk-based capital purposes, and (2) a system for calculating risk-weighted assets by assigning assets and off balance sheet items to broad risk categories. A bank's risk-based capital ratio is calculated by dividing its qualifying total capital base (the numerator of the ratio) by its risk-weighted assets (the denominator).1 Table I outlines the definition of capital and provides a general explanation of how the risk-based capital ratio is calculated. Table II summarizes the risk weights and risk categories, and Table III sets forth the credit conversation factors for off-balance sheet items. Additional explanations of the capital definitions, the riskweighted asset calculations, and the minimum risk-based capital ratio guidelines are provided in Sections I, II and III of this statement of policy.

In addition, when certain banks that engage in trading activities calculate their risk-based capital ratio under this appendix A, they must also refer to appendix C of this part, which incorporates capital charges for certain market risks into the risk-based capital ratio. When calculating their risk-based capital ratio under this appendix A, such banks are required to refer to appendix C of this part for supplemental rules to determine qualifying and excess capital, calculate risk-weighted assets, calculate market risk equivalent assets and add them to risk-

weighted assets, and calculate risk-based capital ratios as adjusted for market risk.

This statement of policy applies to all FDIC-insured state-chartered banks (excluding insured branches of foreign banks) that are not members of the Federal Reserve System, hereafter referred to as state nonmember banks, regardless of size, and to all circumstances in which the FDIC is required to evaluate the capital of a banking organization. Therefore, the risk-based capital framework set forth in this statement of policy will be used in the examination and supervisory process as well as in the analysis of applications that the FDIC is required to act upon.

The risk-based capital ratio focuses principally on broad categories of credit risk, however, the ratio does not take account of many other factors that can affect a bank's financial condition. These factors include overall interest rate risk exposure, liquidity, funding and market risks; the quality and level of earnings; investment, loan portfolio, and other concentrations of credit risk, certain risks arising from nontraditional activities: the quality of loans and investments: the effectiveness of loan and investment policies; and management's overall ability to monitor and control financial and operating risks, including the risk presented by concentrations of credit and nontraditional activities. In addition to evaluating capital ratios, an overall assessment of capital adequacy must take account of each of these other factors, including, in particular, the level and severity of problem and adversely classified assets as well as a bank's interest rate risk as measured by the bank's exposure to declines in the economic value of its capital due to changes in interest rates. For this reason, the final supervisory judgment on a bank's capital adequacy may differ significantly from the conclusions that might be drawn solely from the absolute level of the bank's risk-based capital ratio.

In light of these other considerations, banks generally are expected to operate above the minimum risk-based capital ratio. Banks contemplating significant expansion plans, as well as those institutions with high or inordinate levels of risk, should hold capital commensurate with the level and nature of the risks to which they are exposed.

I. DEFINITION OF CAPITAL FOR THE RISK-BASED CAPITAL RATIO

A bank's qualifying total capital base consists of two types of capital elements: core capital elements (Tier 1) and supplementary capital elements (Tier 2). To qualify as an element of Tier 1 or Tier 2 capital, a capital instrument should not contain or be subject to any conditions, covenants, terms, restrictions, or provisions that are inconsistent with safe and sound banking practices.

¹Period-end amounts, rather than average balances, normally will be used when calculating risk-based capital ratios. However, on a case-by-case basis, ratios based on average balances may also be required if supervisory concerns render it appropriate.

- A. The Components of Qualifying Capital (see Table I)
- 1. Core capital elements (Tier 1) consists of:
- i. Common stockholders' equity capital (includes common stock and related surplus, undivided profits, disclosed capital reserves that represent a segregation of undivided profits, and foreign currency translation adjustments, less net unrealized holding losses on available-for-sale equity securities with readily determinable fair values);
- ii. Noncumulative perpetual preferred stock, including any related surplus; and iii. Minority interests in the equity capital
- iii. Minority interests in the equity capital accounts of consolidated subsidiaries.

At least 50 percent of the qualifying total capital base should consist of Tier 1 capital. Core (Tier 1) capital is defined as the sum of core capital elements minus all intangible assets (other than mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships eligible for inclusion in core capital pursuant to §325.5(f)), 3 minus credit-enhancing interest-only strips that are not eligible for inclusion in core capital pursuant to §325.5(f)), and minus any disallowed deferred tax assets.

Although nonvoting common stock, noncumulative perpetual preferred stock, and minority interests in the equity capital accounts of consolidated subsidiaries are normally included in Tier 1 capital, voting common stockholders' equity generally will be expected to be the dominant form of Tier 1 capital. Thus, banks should avoid undue reliance on nonvoting equity, preferred stock and minority interests.

Although minority interests in consolidated subsidiaries are generally included in regulatory capital, exceptions to this general rule will be made if the minority interests fail to provide meaningful capital support to the consolidated bank. Such a situation could arise if the minority interests are entitled to a preferred claim on essentially low risk assets of the subsidiary. Similarly, although credit-enhancing interest-only strips and intangible assets in the form of mortgage servicing assets, nonmortgage servicing assets and purchased credit card relation-

ships are generally recognized for risk-based capital purposes, the deduction of part or all of the credit-enhancing interest-only strips, mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships may be required if the carrying amounts of these assets are excessive in relation to their market value or the level of the bank's capital accounts. Credit-enhancing interest-only strips, mortgage servicing assets, nonmortgage servicing assets, purchased credit card relationships and deferred tax assets that do not meet the conditions, limitations and restrictions described in §325.5(f) and (g) of this part will not be recognized for risk-based capital purposes.

- 2. Supplementary capital elements (Tier 2) consist of:
- i. Allowance for loan and lease losses, up to a maximum of 1.25 percent of risk-weighted assets:
- ii. Cumulative perpetual preferred stock, long-term preferred stock (original maturity of at least 20 years), and any related surplus;
- iii. Perpetual preferred stock (and any related surplus) where the dividend is reset periodically based, in whole or part, on the bank's current credit standing, regardless of whether the dividends are cumulative or noncumulative;
- iv. Hybrid capital instruments, including mandatory convertible debt securities:
- v. Term subordinated debt and intermediate-term preferred stock (original average maturity of five years or more) and any related surplus: and
- vi. Net unrealized holding gains on equity securities (subject to the limitations discussed in paragraph I.A.2.(f) of this section).

The maximum amount of Tier 2 capital that may be recognized for risk-based capital purposes is limited to 100 percent of Tier 1 capital (after any deductions for disallowed intangibles and disallowed deferred tax assets). In addition, the combined amount of term subordinated debt and intermediate-term preferred stock that may be treated as part of Tier 2 capital for risk-based capital purposes is limited to 50 percent of Tier 1 capital. Amounts in excess of these limits may be issued but are not included in the calculation of the risk-based capital ratio.

(a) Allowance for loan and lease losses. Allowances for loan and lease losses are reserves that have been established through a charge against earnings to absorb future losses on loans or lease financing receivables. Allowances for loan and lease losses exclude allocated transfer risk reserves, 4 and reserves created against identified losses.

²Preferred stock issues where the dividend is reset periodically based, in whole or in part, upon the bank's current credit standing, including but not limited to, auction rate, money market or remarketable preferred stock, are assigned to Tier 2 capital, regardless of whether the dividends are cumulative or noncumulative.

³An exception is allowed for intangible assets that are explicitly approved by the FDIC as part of the bank's regulatory capital on a specific case basis. These intangibles will be included in capital for risk-based capital purposes under the terms and conditions that are specifically approved by the FDIC.

⁴Allocated transfer risk reserves are reserves that have been established in accordance with section 905(a) of the International Lending Supervision Act of 1983 against certain assets whose value has been found by

This risk-based capital framework provides a phasedown during the transition period of the extent to which the allowance for loan and lease losses may be included in an institution's capital base. By year-end 1990, the allowance for loan and lease losses, as an element of supplementary capital, may constitute no more than 1.5 percent of risk-weighted assets and, by year-end 1992, no more than 1.25 percent of risk-weighted assets.⁵

(b) Preferred stock. Perpetual preferred stock is defined as preferred stock that does not have a maturity date, that cannot be redeemed at the option of the holder, and that has no other provisions that will require future redemption of the issue. Long-term preferred stock includes limited-life preferred stock with an original maturity of 20 years or more, provided that the stock cannot be redeemed at the option of the holder prior to maturity, except with the prior approval of the FDIC.

Cumulative perpetual preferred stock and long-term preferred stock qualify for inclusion in supplementary capital provided that the instruments can absorb losses while the issuer operates as a going concern (a fundamental characteristic of equity capital) and provided the issuer has the option to defer payment of dividends on these instruments. Given these conditions, and the perpetual or long-term nature of the intruments, there is no limit on the amount of these preferred stock instruments that may be included with Tier 2 capital.

Noncumulative perpetual preferred stock where the dividend is reset periodically based, in whole or in part, on the bank's current credit standing, including auction rate, money market, or remarketable preferred stock, are also assigned to Tier 2 capital without limit, provided the above conditions are met.

(c) Hybrid capital instruments. Hybrid capital instruments include instruments that have certain characteristics of both debt and equity. In order to be included as supplementary capital elements, these instruments should meet the following criteria:

the U.S. supervisory authorities to have been significantly impaired by protracted transfer risk problems.

⁵The amount of the allowance for loan and lease losses that may be included as a supplementary capital element is based on a percentage of gross risk-weighted assets. A bank may deduct reserves for loan and lease losses that are in excess of the amount permitted to be included in capital, as well as allocated transfer risk reserves, from gross risk-weighted assets when computing the denominator of the risk-based capital ratio.

- (1) The instrument should be unsecured, subordinated to the claims of depositors and general creditors, and fully paid-up.
- (2) The instrument should not be redeemable at the option of the holder prior to maturity, except with the prior approval of the FDIC. This requirement implies that holders of such instruments may not accelerate the payment of principal except in the event of bankruptcy, insolvency, or reorganization.
- (3) The instrument should be available to participate in losses while the issuer is operating as a going concern. (Term subordinated debt would not meet this requirement.) To satisfy this requirement, the instrument should convert to common or perpetual preferred stock in the event that the sum of the undivided profits and capital surplus accounts of the issuer results in a negative balance
- (4) The instrument should provide the option for the issuer to defer principal and interest payments if: (a) The issuer does not report a profit in the preceding annual period, defined as combined profits (i.e., net income) for the most recent four quarters, and (b) the issuer eliminates cash dividends on its common and preferred stock.

Mandatory convertible debt securities, which are subordinated debt instruments that require the issuer to convert such instruments into common or perpetual preferred stock by a date at or before the maturity of the debt instruments, will qualify as hybrid capital instruments provided the maturity of these instruments is 12 years or less and the instruments meet the criteria set forth below for "term subordinated debt." There is no limit on the amount of hybrid capital instruments that may be included within Tier 2 capital.

- (d) Term subordinated debt and intermediateterm preferred stock. The aggregate amount of term subordinated debt (excluding mandatory convertible debt securities) and intermediate-term preferred stock (including any related surplus) that may be treated as Tier 2 capital for risk-based capital purposes is limited to 50 percent of Tier 1 capital. Term subordinated debt and intermediate-term preferred stock should have an original average maturity of at least five years to qualify as supplementary capital and should not be redeemable at the option of the holder prior to maturity, except with the prior approval of the FDIC. For state nonmember banks, a term subordinated debt instrument is an obligation other than a deposit obligation that:
- (1) Bears on its face, in boldface type, the following: This obligation is not a deposit and is not insured by the Federal Deposit Insurance Corporation;
- (2)(i) Has a maturity of at least five years; or
- (ii) In the case of an obligation or issue that provides for scheduled repayments of principal, has an average maturity of at

least five years; provided that the Director of the Division of Supervision may permit the issuance of an obligation or issue with a shorter maturity or average maturity if the Director has determined that exigent circumstances require the issuance of such obligation or issue; provided further that the provisions of this paragraph I.A.2.(d)(2) shall not apply to mandatory convertible debt obligations or issues:

- (3) States express that the obligation:
- (i) Is subordinated and junior in right of payment to the issuing bank's obligations to its depositors and to the bank's other obligations to its general and secured creditors; and
- (ii) Is ineligible as collateral for a loan by the issuing bank;
 - (4) Is unsecured;
- (5) States expressly that the issuing bank may not retire any part of its obligation without the prior written consent of the FDIC or other primary federal regulator; and
- (6) Includes, if the obligation is issued to a depository institution, a specific waiver of the right of offset by the lending depository institution.

Subordinated debt obligations issued prior to December 2, 1987 that satisfied the definition of the term "subordinated note and debenture" that was in effect prior to that date also will be deemed to be term subordinated debt for risk-based capital purposes. An optional redemption ("call") provision in a subordinated debt instrument that is exercisable by the issuing bank in less than five vears will not be deemed to constitute a maturity of less than five years, provided that the obligation otherwise has a stated contractual maturity of at least five years; the call is exercisable solely at the discretion or option of the issuing bank, and not at the discretion or option of the holder of the obligation; and the call is exercisable only with the express prior written consent of the FDIC under 12 U.S.C. 1828(i)(1) at the time early redemption or retirement is sought, and such consent has not been given in advance at the time of issuance of the obligation. Optional redemption provisions will be accorded similar treatment when determining the perpetual nature and/or maturity of preferred stock and other capital instruments.

(e) Discount of limited-life supplementary capital instruments. As a limited-life capital instrument approaches maturity, the instrument begins to take on charcteristics of a short-term obligation and becomes less like a component of capital. Therefore, for risk-based capital purposes, the outstanding amount of term subordinated debt and limited-life preferred stock eligible for inclusion in capital will be adjusted downward, or discounted, as the instruments approach maturity. Each limited-life capital instrument will be discounted by reducing the out-

standing amount of the capital instrument eligible for inclusion as supplementary capital by a fifth of the original amount (less redemptions) each year during the instrument's last five years before maturity. Such instruments, therefore, will have no capital value when they have a remaining maturity of less than a year.

(f) Unrealized gains on equity securities and unrealized gains (losses) on other assets. Up to 45 percent of pretax net unrealized holding gains (that is, the excess, if any, of the fair value over historical cost) on available-forsale equity securities with readily determinable fair values may be included in supplementary capital. However, the FDIC may exclude all or a portion of these unrealized gains from Tier 2 capital if the FDIC determines that the equity securities are not prudently valued. Unrealized gains (losses) on other types of assets, such as bank premises and available-for-sale debt securities, are not included in supplementary capital, but the FDIC may take these unrealized gains (losses) into account as additional factors when assessing a bank's overall capital adequacy.

B. Deductions from Capital and Other Adjustments

Certain assets are deducted from a bank's capital base for the purpose of calculating the numerator of the risk-based capital ratio.⁶ These assets include:

(1) All intangible assets other than mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships. These disallowed intangibles are deducted from the core capital (Tier 1) elements.

⁶Any assets deducted from capital when computing the numerator of the risk-based capital ratio will also be excluded from risk-weighted assets when computing the denominator of the ratio.

⁷In addition to mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships, certain other intangibles may be allowed if explicitly approved by the FDIC as part of the bank's regulatory capital on a specific case basis. In evaluating whether other types of intangibles should be recognized for regulatory capital purposes on a specific case basis, the FDIC will accord special attention to the general characteristics of the intangibles, including: (1) The separability of the intangible asset and the ability to sell it separate and apart from the bank or the bulk of the bank's assets. (2) the certainty that a readily identifiable stream of cash flows associated with the intangible asset can hold its value notwithstanding the future prospects of the bank, and (3) the existence of a market of

- (2) Investments in unconsolidated banking and finance subsidiaries.⁸ This includes any equity or debt capital investments in banking or finance subsidaries if the subsidiaries are not consolidated for regulatory capital requirements.⁹ Generally, these investments include equity and debt capital securities and any other instruments or commitments that are deemed to be capital of the subsidiary. These investments are deducted from the bank's total (Tier 1 plus Tier 2) capital base.
- (3) Investments in *securities subsidiaries* established pursuant to 12 CFR 337.4. The FDIC

sufficient depth to provide liquidity for the intangible asset.

⁸For risk-based capital purposes, these subsidiaries are generally defined as any company that is primarily engaged in banking or finance and in which the bank, either directly or indirectly, owns more than 50 percent of the outstanding voting stock but does not consolidate the company for regulatory capital purposes. In addition to investments in unconsolidated banking and finance subsidiaries, the FDIC may, on a caseby-case basis, deduct investments in associated companies or joint ventures, which are generally defined as any companies in which the bank, either directly or indirectly, owns 20 to 50 percent of the outstanding voting stock. Alternatively, the FDIC may, in certain cases, apply an appropriate risk-weighted capital charge against a bank's proportionate interest in the assets of associated companies and joint ventures. The definitions for subsidiaries, associated companies and joint ventures are contained in the instructions for the preparation of the Consolidated Reports of Condition and Income.

⁹Consolidation requirements for regulatory capital purposes generally follow the consolidation requirements set forth in the instructions for preparation of the consolidated Reports of Condition and Income. However, although investments in subsidiaries representing majority ownership in another Federally-insured depository institution are not consolidated for purposes of the consolidated Reports of Condition and Income that are filed by the parent bank, they are generally consolidated for purposes of determining FDIC regulatory capital requirements. Therefore, investments in these depository institution subsidiaries generally will not be deducted for risk-based capital purposes; rather, assets and liabilities of such subsidiaries will be consolidated with those of the parent bank when calculating the risk-based capital ratio. In addition, although securities subsidiaries established pursuant to 12 CFR 337.4 are consolidated for Report of Condition and Income purposes. they are not consolidated for regulatory capital purposes.

may also consider deducting investments in other subsidiaries, either on a case-by-case basis or, as with securities subsidiaries, based on the general characteristics or functional nature of the subsidiaries.

- (4) Reciprocal holdings of capital instruments of banks that represent intentional cross-holdings by the banks. These holdings are deducted from the bank's total capital base
- (5) Deferred tax assets in excess of the limit set forth in §325.5(g). These disallowed deferred tax assets are deducted from the core capital (Tier 1) elements.

On a case-by-case basis, and in conjunction with supervisory examinations, other deductions from capital may also be required, including any adjustments deemed appropriate for assets classified as loss.

II. PROCEDURES FOR COMPUTING RISK-WEIGHTED ASSETS

A. General Procedures

- 1. Under the risk-based capital framework, a bank's balance sheet assets and credit equivalent amounts of off-balance sheet items are assigned to one of four broad risk categories according to the obligor or, if relevent, the guarantor or the nature of the collateral. The aggregate dollar amount in each category is then multiplied by the risk weight assigned to that category. The resulting weighted values from each of the four risk categories are added together and this sum is the risk-weighted assets total that, as adjusted. To comprises the denominator of the risk-based capital ratio.
- 2. The risk-weighted amounts for all off-balance sheet items are determined by a two-step process. First, the notional principal, or face value, amount of each off-balance sheet item generally is multiplied by a credit conversion factor to arrive at a balance sheet credit equivalent amount. Second, the credit equivalent amount generally is assigned to the appropriate risk category, like any balance sheet asset, according to the obligor or, if relevant, the guarantor or the nature of the collateral.
- 3. The Director of the Division of Supervision may, on a case-by-case basis, determine the appropriate risk weight for any asset or credit equivalent amount that does not fit wholly within one of the risk categories set forth in this Appendix A or that imposes risks on a bank that are not commensurate with the risk weight otherwise specified in this Appendix A for the asset or credit equivalent amount. In addition, the

¹⁰ Any asset deducted from a bank's capital accounts when computing the numerator of the risk-based capital ratio will also be excluded from risk-weighted assets when calculating the denominator for the ratio.

Director of the Division of Supervision may. on a case-by-case basis, determine the appropriate credit conversion factor for any offbalance sheet item that does not fit wholly within one of the credit conversion factors set forth in this Appendix A or that imposes risks on a bank that are not commensurate with the credit conversion factor otherwise specified in this Appendix A for the off-balance sheet item. In making such a determination, the Director of the Division of Supervision will consider the similarity of the asset or off-balance sheet item to assets or off-balance sheet items explicitly treated in sections II.B and II.C of this appendix A, as well as other relevant factors.

B. Other Considerations

1. Indirect Holdings of Assets. Some of the assets on a bank's balance sheet may represent an indirect holding of a pool of assets; for example, mutual funds. An investment in shares of a mutual fund whose portfolio consists solely of various securities or money market instruments that, if held separately, would be assigned to different risk categories, generally is assigned to the risk category appropriate to the highest risk-weighted asset that the fund is permitted to hold in accordance with the stated investment objectives set forth in its prospectus. The bank may, at its option, assign the investment on a pro rata basis to different risk categories according to the investment limits in the fund's prospectus, but in no case will indirect holdings through shares in any mutual fund be assigned to a risk weight less than 20 percent. If the bank chooses to assign its investment on a pro rata basis, and the sum of the investment limits in the fund's prospectus exceeds 100 percent, the bank must assign risk weights in descending order. If, in order to maintain a necessary degree of short-term liquidity, a fund is permitted to hold an insignificant amount of its assets in short-term, highly liquid securities of superior credit quality that do not qualify for a preferential risk weight, such securities will generally be disregarded in determining the risk category to which the bank's holdings in the overall fund should be assigned. The prudent use of hedging instruments by a mutual fund to reduce the risk of its assets will not increase the risk weighting of the mutual fund investment. For example, the use of hedging instruments by a mutual fund to reduce the interest rate risk of its government bond portfolio will not increase the risk weight of that fund above the 20 percent category. Nonetheless, if the fund engages in any activities that appear speculative in nature or has any other characteristics that are inconsistent with the preferential risk weighting assigned to the fund's assets, holdings in the fund will be assigned to the 100 percent risk category.

2. Collateral. In determining risk weights of various assets, the only forms of collateral that are formally recognized by the riskbased capital framework are cash on deposit in the lending bank; securities issued or guaranteed by the central governments of the OECD-based group of countries,11 U.S. Government agencies, or U.S. Governmentsponsored agencies; and securities issued or guaranteed by multilateral lending institutions or regional development banks. Claims fully secured by such collateral are assigned to the 20 percent risk category. The extent to which these securities are recognized as collateral for risk-based capital purposes is determined by their current market value. If a claim is partially secured, the portion of the claim that is not covered by the collateral is assigned to the risk category appropriate to the obligor or, if relevant, the guarantor.

3. Guarantees. Guarantees of the OECD and non-OECD central governments, U.S. Government agencies, U.S. Government-sporsored agencies, state and local governments of the OECD-based group of countries, multilateral lending institutions and regional development banks, U.S. depository institutions and foreign banks are also recognized. If a claim is partially guaranteed, the portion of the claim that is not fully covered by the guarantee is assigned to the risk category appropriate to the obligor or, if relevant, the collateral.

11 The OECD-based group of countries comprises all full members of the Organization for Economic Cooperation and Development (OECD) regardless of entry date, as well as countries that have concluded special lending arrangements with the International Monetary Fund (IMF) associated with the IMF's General Arrangements to Borrow, but excludes any country that has rescheduled its external sovereign debt within the previous five years. As of November 1995, the OECD included the following countries: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States; and Saudi Arabia had concluded special lending arrangements with the IMF associated with the IMF's General Arrangements to Borrow. A rescheduling of external sovereign debt generally would include any renegotiation of terms arising from a country's inability or unwillingness to meet its external debt service obligations, but generally would not include renegotiations of debt in the normal course of business, such as a renegotiation to allow the borrower to take advantage of a decline in interest rates or other change in market conditions.

- 4. Maturity. Maturity is generally not a factor in assigning items to risk categories with the exceptions of claims on non-OECD banks, commitments, and interest rate and foreign exchange rate related contracts. Except for commitments, short-term is defined as one year or less remaining maturity and long-term is defined as over one year remaining maturity. In the case of commitments, short-term is defined as one year or less original maturity and long-term is defined as over one year original maturity.
- 5. Recourse, Direct Credit Substitutes, Residual Interests and Mortgage- and Asset-Backed Securities. For purposes of this section II.B.5 of this appendix A, the following definitions will apply.
- (a) Definitions. (1) Credit derivative means a contract that allows one party (the protection purchaser) to transfer the credit risk of an asset or off-balance sheet credit exposure to another party (the protection provider). The value of a credit derivative is dependent, at least in part, on the credit performance of a "reference asset."
- (2) Credit-enhancing interest-only strip is defined in §325.2(g).
- (3) Credit-enhancing representations and warranties means representations and warranties that are made or assumed in connection with a transfer of assets (including loan servicing assets) and that obligate a bank to protect investors from losses arising from credit risk in the assets transferred or the loans serviced. Credit-enhancing representations and warranties include promises to protect a party from losses resulting from the default or nonperformance of another party or from an insufficiency in the value of the collateral. Credit-enhancing representations and warranties do not include:
- (i) Early-default clauses and similar warranties that permit the return of, or premium refund clauses covering, 1–4 family residential first mortgage loans (as described in section II.C, Category 3–50 Percent Risk Weight, of this appendix A) for a period of 120 days from the date of transfer. These warranties may cover only those loans that were originated within 1 year of the date of transfer;
- (ii) Premium refund clauses covering assets guaranteed, in whole or in part, by the U.S. Government, a U.S. Government agency, or a U.S. Government-sponsored agency, provided the premium refund clauses are for a period not to exceed 120 days from the date of transfer; or
- (iii) Warranties that permit the return of assets in instances of fraud, misrepresentation, or incomplete documentation.
- ¹²Through year-end 1992, remaining rather than original maturity may be used for determining term to maturity for commitments

- (4) Direct credit substitute means an arrangement in which a bank assumes, in form or in substance, credit risk directly or indirectly associated with an on-or off-balance sheet asset or exposure that was not previously owned by the bank (third-party asset) and the risk assumed by the bank exceeds the prorata share of the bank's interest in the third-party asset. If the bank has no claim on the asset, then the bank's assumption of any credit risk is a direct credit substitute. Direct credit substitutes include, but are not limited to:
- (i) Financial standby letters of credit, which includes any letter of credit or similar arrangement, however named or described, that support financial claims on a third party that exceed a bank's pro rata share in the financial claim;
- (ii) Guarantees, surety arrangements, credit derivatives, and irrevocable guarantee-type instruments backing financial claims such as outstanding securities, loans, or other financial claims, or that back off-balance-sheet items against which risk-based capital must be maintained;
- (iii) Purchased subordinated interests or securities that absorb more than their prorata share of credit losses from the underlying assets. Purchased subordinated interests that are credit-enhancing interest-only strips are subject to the higher capital charge specified in section II.B.5.(f) of this Appendix A;
- (iv) Entering into a credit derivative contract under which the bank assumes more than its *pro rata* share of credit risk on a third-party asset or exposure;
- (v) Loans or lines of credit that provide credit enhancement for the financial obligations of an account party;
- (vi) Purchased loan servicing assets if the servicer:
- (A) Is responsible for credit losses associated with the loans being serviced,
- (B) Is responsible for making mortgage servicer cash advances (unless the advances are not direct credit substitutes because they meet the conditions specified in paragraph B.5(a)(9) of this appendix A), or
- (C) Makes or assumes credit-enhancing representations and warranties on the serviced loans; and
- (vii) Clean-up calls on third party assets. Clean-up calls that are exercisable at the option of the bank (as servicer or as an affiliate of the servicer) when the pool balance is 10 percent or less of the original pool balance are not direct credit substitutes.
- (5) Externally rated means, with respect to an instrument or obligation, that an instrument or obligation has received a credit rating from at least one nationally recognized statistical rating organization.
 - (6) Face amount is defined in §325.2(h).

- (7) Financial asset means cash, evidence of an ownership interest in an entity, or a contract that conveys to a second entity a contractual right:
- (i) To receive cash or another financial instrument from a first entity; or
- (ii) To exchange other financial instruments on potentially favorable terms with the first entity.
- (8) Financial standby letter of credit means a letter of credit or similar arrangement that represents an irrevocable obligation to a third-party beneficiary:
- (i) To repay money borrowed by, or advanced to, or for the account of, a second party (the account party); or
- (ii) To make payment on behalf of the account party, in the event that the account party fails to fulfill its obligation to the beneficiary.
- (9) Mortgage servicer cash advance means funds that a residential mortgage servicer advances to ensure an uninterrupted flow of payments or the timely collection of residential mortgage loans, including disbursements made to cover foreclosure costs or other expenses arising from a mortgage loan to facilitate its timely collection. A mortgage servicer cash advance is not a recourse obligation or a direct credit substitute if:
- (i) The mortgage servicer is entitled to full reimbursement or, for any one residential mortgage loan, nonreimbursable advances are contractually limited to an insignificant amount of the outstanding principal on that loan, and
- (ii) The servicer's entitlement to reimbursement is not subordinated.
- (10) Nationally recognized statistical rating organization (NRSRO) means an entity recognized by the Division of Market Regulation of the Securities and Exchange Commission (or any successor Division) (Commission) as a nationally recognized statistical rating organization for various purposes, including the Commission's uniform net capital requirements for brokers and dealers (17 CFR 240.15c3-1).
- (11) Recourse means an arrangement in which a bank retains, in form or in substance, any credit risk directly or indirectly associated with an asset it has sold (in accordance with generally accepted accounting principles) that exceeds a pro rata share of the bank's claim on the asset. If a bank has no claim on an asset it has sold, then the retention of any credit risk is recourse. A recourse obligation typically arises when an institution transfers assets in a sale and retains an obligation to repurchase the assets or absorb losses due to a default of principal or interest or any other deficiency in the performance of the underlying obligor or some other party. Recourse may exist implicitly where a bank provides credit enhancement beyond any contractual obligation to support assets it has sold. The fol-

lowing are examples of recourse arrangements:

- (i) Credit-enhancing representations and warranties made on the transferred assets;
- (ii) Loan servicing assets retained pursuant to an agreement under which the bank:
- (A) Is responsible for losses associated with the loans serviced.
- (B) Is responsible for making mortgage servicer cash advances (unless the advances are not a recourse obligation because they meet the conditions of paragraph B.5(a)(9) of this appendix A), or
- (C) Makes credit-enhancing representations and warranties on the serviced loans;
- (iii) Retained subordinated interests that absorb more than their pro rata share of losses from the underlying assets;
- (iv) Assets sold under an agreement to repurchase, if the assets are not already included on the balance sheet;
- (v) Loan strips sold without contractual recourse where the maturity of the transferred portion of the loan is shorter than the maturity of the commitment under which the loan is drawn;
- (vi) Credit derivative contracts under which the bank retains more than its pro rata share of credit risk on transferred assets; and
- (vii) Clean-up calls. Clean-up calls that are exercisable at the option of the bank (as servicer or as an affiliate of the servicer) when the pool balance is 10 percent or less of the original pool balance, are not recourse.
- (12) Residual interest means any on-balance sheet asset that represents an interest (including a beneficial interest) created by a transfer that qualifies as a sale (in accordance with generally accepted accounting principles) of financial assets, whether through a securitization or otherwise, and that exposes a bank to credit risk directly or indirectly associated with the transferred asset that exceeds a pro rata share of that bank's claim on the asset, whether through subordination provisions or other credit enhancement techniques. Residual interests generally include credit-enhancing interestonly strips, spread accounts, cash collateral accounts, retained subordinated interests and other forms of over-collateralization, and similar assets that function as a credit enhancement. Residual interests further include those exposures that, in substance, cause the bank to retain the credit risk of an asset or exposure that had qualified as a residual interest before it was sold. Residual interests generally do not include interests purchased from a third party, except that purchased credit-enhancing interest-only strips are residual interests.
- (13) Risk participation means a participation in which the originating bank remains liable to the beneficiary for the full amount of an obligation (e.g. a direct credit substitute)

notwithstanding that another party has acquired a participation in that obligation.

- (14) Securitization means the pooling and repackaging by a special purpose entity of assets or other credit exposures into securities that can be sold to investors. Securitization includes transactions that generally create stratified credit risk positions whose performance is dependent upon an underlying pool of credit exposures, including loans and commitments.
- (15) Structured finance program means a program where receivable interests and assetbacked securities issued by multiple participants are purchased by a special purpose entity that repackages those exposures into securities that can be sold to investors. Structured finance programs allocate credit risks, generally, between the participants and the credit enhancement provided to the program.
- (16) Traded position means a position or asset-backed security retained, assumed or issued in connection with a securitization that is externally rated, where there is a reasonable expectation that, in the near future, the rating will be relied upon by:
- (i) Unaffiliated investors to purchase the position; or
- (ii) An unaffiliated third party to enter into a transaction involving the position, such as a purchase, loan or repurchase agreement.
- (b) Credit equivalent amounts and risk weights of recourse obligations and direct credit substitutes—(1) General rule for determining the credit-equivalent amount. Except as otherwise provided, the credit-equivalent amount for a recourse obligation or direct credit substitute is the full amount of the credit-enhanced assets for which the bank directly or indirectly retains or assumes credit risk multiplied by a 100% conversion factor. Thus, a bank that extends a partial direct credit substitute, e.g., a financial standby letter of credit that absorbs the first 10 percent of loss on a transaction, must maintain capital against the full amount of the assets being supported.
- (2) Risk-weight factor. To determine the bank's risk-weighted assets for an off-balance sheet recourse obligation or a direct credit substitute, the credit equivalent amount is assigned to the risk category appropriate to the obligor in the underlying transaction, after considering any associated guarantees or collateral. For a direct credit substitute that is an on-balance sheet asset. e.g., a purchased subordinated security, a bank must calculate risk-weighted assets using the amount of the direct credit substitute and the full amount of the assets it supports, i.e., all the more senior positions in the structure. The treatment covered in this paragraph (b) is subject to the low-level exposure rule provided in section II.B.5(h)(1) of this appendix A.

- (c) Credit equivalent amount and risk weight of participations in, and syndications of, direct credit substitutes. Subject to the low-level exposure rule provided in section II.B.5(h)(1) of this appendix A, the credit equivalent amount for a participation interest in, or syndication of, a direct credit substitute (excluding purchased credit-enhancing interest-only strips) is calculated and risk weighted as follows:
- (1) Treatment for direct credit substitutes for which a bank has conveyed a risk participation. In the case of a direct credit substitute in which a bank has conveyed a risk participation, the full amount of the assets that are supported by the direct credit substitute is converted to a credit equivalent amount using a 100% conversion factor. However, the pro rata share of the credit equivalent amount that has been conveyed through a risk participation is then assigned to whichever risk-weight category is lower: the riskweight category appropriate to the obligor in the underlying transaction, after considering any associated guarantees or collateral, or the risk-weight category appropriate to the party acquiring the participation. The pro rata share of the credit equivalent amount that has not been participated out is assigned to the risk-weight category appropriate to the obligor, guarantor, or collateral. For example, the pro rata share of the full amount of the assets supported, in whole or in part, by a direct credit substitute conveyed as a risk participation to a U.S. domestic depository institution or an OECD bank is assigned to the 20 percent risk category.13
- (2) Treatment for direct credit substitutes in which the bank has acquired a risk participation. In the case of a direct credit substitute in which the bank has acquired a risk participation, the acquiring bank's pro rata share of the direct credit substitute is multiplied by the full amount of the assets that are supported by the direct credit substitute and converted using a 100% credit conversion factor. The resulting credit equivalent amount is then assigned to the risk-weight category appropriate to the obligor in the underlying transaction, after considering any associated guarantees or collateral.
- (3) Treatment for direct credit substitutes related to syndications. In the case of a direct credit substitute that takes the form of a syndication where each party is obligated only for its pro rata share of the risk and there is no recourse to the originating entity, each bank's credit equivalent amount will be calculated by multiplying only its pro rata share of the assets supported by the

¹³ A risk participation with a remaining maturity of one year or less that is conveyed to a non-OECD bank is also assigned to the 20 percent risk category.

direct credit substitute by a 100% conversion factor. The resulting credit equivalent amount is then assigned to the risk-weight category appropriate to the obligor in the underlying transaction, after considering any associated guarantees or collateral.

(d) Externally rated positions: credit-equivalent amounts and risk weights.—(1) Traded positions. With respect to a recourse obligation, direct credit substitute, residual interest (other than a credit-enhancing interest-only strip) or mortgage- or asset-backed security

that is a "traded position" and that has received an external rating on a long-term position that is one grade below investment grade or better or a short-term position that is investment grade, the bank may multiply the face amount of the position by the appropriate risk weight, determined in accordance with Table A or B of this appendix A, as appropriate. If a traded position receives more than one external rating, the lowest rating will apply.

TABLE A

Long-term rating category	Examples	Risk weight (In percent)
	ABBB	20 50 100 200

TABLE B

Short-term rating category	Examples	Risk weight (In percent)
Highest investment grade		20
Second highest investment grade	A-2, P-2	50
Lowest investment grade	A-3, P-3	100

- (2) Non-traded positions. A recourse obligation, direct credit substitute, residual interest (but not a credit-enhancing interest-only strip) or mortgage- or asset-backed security extended in connection with a securitization that is not a "traded position" may be assigned a risk weight in accordance with section II.B.5(d)(1) of this appendix A if:
- (i) It has been externally rated by more than one NRSRO;
- (ii) It has received an external rating on a long-term position that is one category below investment grade or better or a shortterm position that is investment grade by all NRSROs providing a rating;
- (iii) The ratings are publicly available; and (iv) The ratings are based on the same criteria used to rate traded positions. If the ratings are different, the lowest rating will determine the risk category to which the recourse obligation, direct credit substitute, residual interest, or mortgage- or assetbacked security will be assigned.
- (e) Senior positions not externally rated. For a recourse obligation, direct credit substitute, residual interest or mortgage- or asset-backed security that is not externally rated but is senior in all features to a traded position (including collateralization and maturity), a bank may apply a risk weight to

- the face amount of the senior position in accordance with section II.B.5(d)(1) of this appendix A, based upon the risk weight of the traded position, subject to any current or prospective supervisory guidance and the bank satisfying the FDIC that this treatment is appropriate. This section will apply only if the traded position provides substantial credit support for the entire life of the unrated position.
- (f) Residual interests—(1) Concentration limit on credit-enhancing interest-only strips. In addition to the capital requirement provided by section II.B.5(f)(2) of this appendix A, a bank must deduct from Tier 1 capital the face amount of all credit-enhancing interest-only strips in excess of 25 percent of Tier 1 capital in accordance with §325.5(f)(3).
- (2) Credit-enhancing interest-only strip capital requirement. After applying the concentration limit to credit-enhancing interest-only strips in accordance with §325.5(f)(3), a bank must maintain risk-based capital for a credit-enhancing interest-only strip, equal to the remaining face amount of the credit-enhancing interest-only strip (net of the remaining proportional amount of any existing associated deferred tax liability recorded on the balance sheet), even if the amount of risk-based capital required to be

principal-only strips, must be assigned to the 100% risk category.

¹⁴Stripped mortgage-backed securities and similar instruments, such as interest-only strips that are not credit-enhancing and

maintained exceeds the full risk-based capital requirement for the assets transferred. Transactions that, in substance, result in the retention of credit risk associated with a transferred credit-enhancing interest-only strip will be treated as if the credit-enhancing interest-only strip was retained by the bank and not transferred.

(3) Other residual interests capital requirement. Except as otherwise provided in section II.B.5(d) or (e) of this appendix A, a bank must maintain risk-based capital for a residual interest (excluding a credit-enhancing interest-only strip) equal to the face amount of the residual interest (net of any existing associated deferred tax liability recorded on the balance sheet), even if the amount of risk-based capital required to be maintained exceeds the full risk-based capital requirement for the assets transferred. Transactions that, in substance, result in the retention of credit risk associated with a transferred residual interest will be treated as if the residual interest was retained by the bank and not transferred.

(4) Residual interests and other recourse obligations. Where the aggregate capital require-

ment for residual interests (including creditenhancing interest-only strips) and recourse obligations arising from the same transfer of assets exceed the full risk-based capital requirement for assets transferred, a bank must maintain risk-based capital equal to the greater of the risk-based capital requirement for the residual interest as calculated under sections II.B.5(f)(2) through (3) of this appendix A or the full risk-based capital requirement for the assets transferred.

(g) Positions that are not rated by an NRSRO. A bank's position (other than a residual interest) in a securitization or structured finance program that is not rated by an NRSRO may be risk-weighted based on the bank's determination of the credit rating of the position, as specified in Table C of this appendix A, multiplied by the face amount of the position. In order to qualify for this treatment, the bank's system for determining the credit rating of the position must meet one of the three alternative standards set out in section II.B.5(g)(1) through (3) of this appendix A.

TABLE C

Rating category	Examples	Risk Weight (In percent)	
Investment grade	BBB or better	100 200	

(1) Internal risk rating used for asset-backed programs. A bank extends a direct credit substitute (but not a purchased credit-enhancing interest-only strip) to an asset-backed commercial paper program sponsored by the bank and the bank is able to demonstrate to the satisfaction of the FDIC, prior to relying upon its use, that the bank's internal credit risk rating system is adequate. Adequate internal credit risk rating systems usually contain the following criteria: 15

(i) The internal credit risk rating system is an integral part of the bank's risk management system that explicitly incorporates the full range of risks arising from a bank's participation in securitization activities;

(ii) Internal credit ratings are linked to measurable outcomes, such as the probability that the position will experience any loss, the position's expected loss given default, and the degree of variance in losses given default on that position;

- (iii) The internal credit risk rating system must separately consider the risk associated with the underlying loans or borrowers, and the risk associated with the structure of a particular securitization transaction;
- (iv) The internal credit risk rating system identifies gradations of risk among "pass" assets and other risk positions;
- (v) The internal credit risk rating system must have clear, explicit criteria (including for subjective factors), that are used to classify assets into each internal risk grade:
- (vi) The bank must have independent credit risk management or loan review personnel assigning or reviewing the credit risk ratings;

(vii) An internal audit procedure should periodically verify that internal risk ratings are assigned in accordance with the bank's established criteria;

(viii) The bank must monitor the performance of the internal credit risk ratings assigned to nonrated, nontraded direct credit substitutes over time to determine the appropriateness of the initial credit risk rating assignment and adjust individual credit risk ratings, or the overall internal credit risk ratings system, as needed; and

(ix) The internal credit risk rating system must make credit risk rating assumptions

¹⁵The adequacy of a bank's use of its internal credit risk rating system must be demonstrated to the FDIC considering the criteria listed in this section and the size and complexity of the credit exposures assumed by the bank.

that are consistent with, or more conservative than, the credit risk rating assumptions and methodologies of NRSROs.

- (2) Program Ratings. A bank extends a direct credit substitute or retains a recourse obligation (but not a residual interest) in connection with a structured finance program and an NRSRO has reviewed the terms of the program and stated a rating for positions associated with the program. If the program has options for different combinations of assets, standards, internal credit enhancements and other relevant factors, and the NRSRO specifies ranges of rating categories to them, the bank may apply the rating category applicable to the option that corresponds to the bank's position. In order to rely on a program rating, the bank must demonstrate to the FDIC's satisfaction that the credit risk rating assigned to the program meets the same standards generally used by NRSROs for rating traded positions. The bank must also demonstrate to the FDIC's satisfaction that the criteria underlying the NRSRO's assignment of ratings for the program are satisfied for the particular position issued by the bank. If a bank participates in a securitization sponsored by another party, the FDIC may authorize the bank to use this approach based on a program rating obtained by the sponsor of the program.
- (3) Computer Program. A bank is using an acceptable credit assessment computer program that has been developed by an NRSRO to determine the rating of a direct credit substitute or recourse obligation (but not a residual interest) extended in connection with a structured finance program. In order to rely on the rating determined by the computer program, the bank must demonstrate to the FDIC's satisfaction that ratings under the program correspond credibly and reliably with the ratings of traded positions. The bank must also demonstrate to the FDIC's satisfaction the credibility of the program in financial markets, the reliability of the program in assessing credit risk, the applicability of the program to the bank's position, and the proper implementation of the program.
- (h) Limitations on risk-based capital requirements—(1) Low-level exposure rule. If the maximum exposure to loss retained or assumed by a bank in connection with a recourse obligation, a direct credit substitute, or a residual interest is less than the effective risk-based capital requirement for the credit-enhanced assets, the risk-based capital required under this appendix A is limited to the bank's maximum contractual exposure, less any recourse liability account established in accordance with generally accepted accounting principles. This limitation does not apply when a bank provides credit enhancement beyond any contractual obligation to support assets it has sold.

- (2) Mortgage-related securities or participation certificates retained in a mortgage loan swap. If a bank holds a mortgage-related security or a participation certificate as a result of a mortgage loan swap with recourse, capital is required to support the recourse obligation plus the percentage of the mortgage-related security or participation certificate that is not covered by the recourse obligation. The total amount of capital required for the on-balance sheet asset and the recourse obligation, however, is limited to the capital requirement for the underlying loans, calculated as if the bank continued to hold these loans as an on-balance sheet asset.
- (3) Related on-balance sheet assets. If a recourse obligation or direct credit substitute also appears as a balance sheet asset, the asset is risk-weighted only under this section II.B.5 of this appendix A, except in the case of loan servicing assets and similar arrangements with embedded recourse obligations or direct credit substitutes. In that case, the on-balance sheet servicing assets and the related recourse obligations or direct credit substitutes must both be separately risk weighted and incorporated into the risk-based capital calculation.
- (i) Alternative Capital Calculation for Small Business Obligations.
- (1) Definitions. For purposes of this section II.B. 5(i):
- (i) Qualified bank means a bank that:
- (A) Is well capitalized as defined in $\S 325.103(b)(1)$ without applying the capital treatment described in this section II.B.5(i),
- (B) Is adequately capitalized as defined in §325.103(b)(2) without applying the capital treatment described in this section II.B.5(i) and has received written permission by order of the FDIC to apply the capital treatment described in this section II.B.5(i).
- (iii) Small business means a business that meets the criteria for a small business concern established by the Small Business Administration in 13 CFR part 121 pursuant to 15 U.S.C. 632.
- (2) Capital and reserve requirements. Notwithstanding the risk-based capital treatment outlined in any other paragraph (other than paragraph (i) of this section II.B.5), with respect to a transfer with recourse of a small business loan or a lease to a small business of personal property that is a sale under generally accepted accounting principles, and for which the bank establishes and maintains a non-capital reserve under generally accepted accounting principles sufficient to meet the reasonable estimated liability of the bank under the recourse arrangement: a qualified bank may elect to include only the face amount of its recourse in its risk-weighted assets for purposes of calculating the bank's risk-based capital ratio.

- (3) Limit on aggregate amount of recourse. The total outstanding amount of recourse retained by a qualified bank with respect to transfers of small business loans and leases to small businesses of personal property and included in the risk-weighted assets of the bank as described in section II.B.5(i)(2) of this appendix A may not exceed 15 percent of the bank's total risk-based capital, unless the FDIC specifies a greater amount by order.
- (4) Bank that ceases to be qualified or that exceeds aggregate limit. If a bank ceases to be a qualified bank or exceeds the aggregate limit in section II.B.5(i)(3) of this appendix A, the bank may continue to apply the capital treatment described in section II.B.5(i)(2) of this appendix A to transfers of small business loans and leases to small businesses of personal property that occurred when the bank was qualified and did not exceed the limit.
- (5) Prompt correction action not affected. (i) A bank shall compute its capital without regard to this section II.B.5(i) for purposes of prompt corrective action (12 U.S.C. 18310) unless the bank is a well capitalized bank (without applying the capital treatment described in this section II.B.5(i)) and, after applying the capital treatment described in this section II.B.5(i), the bank would be well capitalized.
- (ii) A bank shall compute its capital without regard to this section II.B.5(i) for purposes of 12 U.S.C. 1831o(g) regardless of the bank's capital level.

C. Risk Weights for Balance Sheet Assets (see Table II)

The risk-based capital framework contains four risk weight categories—0 percent, 20 percent, 50 percent and 100 percent. In general, if a particular item can be placed in more than one risk category, it is assigned to the category that has the lowest risk weight. An explanation of the components of each category follows:

Category 1—Zero Percent Risk Weight. This category includes cash (domestic and foreign) owned and held in all offices of the bank or in transit; balances due from Federal Reserve Banks and central banks in other OECD countries; the portions of local currency claims on or unconditionally guaranteed by non-OECD central governments to the extent that the bank has liabilities booked in that currency; and gold bullion held in the bank's own vaults or in another bank's vaults on an allocated basis, to the extent it is offset by gold bullion liabilities ¹⁶

The zero percent risk category also includes direct claims ¹⁷ (including securities, loans, and leases) on, and the portions of claims that are unconditionally guaranteed by, OECD central governments ¹⁸ and U.S. Government agencies. ¹⁹ Federal Reserve Bank stock also is included in this category.

a. Category 2—20 Percent Risk Weight. This category includes short-term claims (including demand deposits) on, and portions of short-term claims that are guaranteed ²⁰ by,

¹⁷ For purposes of determining the appropriate risk weights for this risk-based capital framework, the terms claims and securities refer to loans or other debt obligations of the entity on whom the claim is held. Investments in the form of stock or equity holdings in commercial or financial firms are generally assigned to the 100 percent risk category.

¹⁸A central government is defined to include departments and ministries, including the central bank, of the central government. The U.S. central bank includes the 12 Federal Reserve Banks. The definition of central government does not include state, provincial or local governments or commercial enterprises owned by the central government. In addition, it does not include local government entities or commercial enterprises whose obligations are guaranteed by the central government. OECD central governments are defined as central governments of the OECD-based group of countries. Non-OECD central governments are defined as central governments of countries that do not belong to the OECD-based group of countries.

¹⁹ For risk-based capital purposes U.S. Government agency is defined as an instrumentality of the U.S. Government whose debt obligations are fully and explicitly guaranteed as to the timely payment of principal and interest by the full faith and credit of the U.S. Government. These agencies include the Government National Mortgage Association (GNMA), the Veterans Administration (VA), the Federal Housing Administration (FHA), the Farmers Home Administration (FHA), the Export-Import Bank (Exim Bank), the Overseas Private Investment Corporation (OPIC), the Commodity Credit Corporation (CCC), and the Small Business Administration (SBA). U.S. Government agencies generally do not directly issue securities to the public; however, a number of U.S. Government agencies, such as GNMA, guarantee securities that are publicly held.

²⁰ Claims guaranteed by U.S. depository institutions and foreign banks include risk participations in both bankers acceptances and standby letters of credit, as well as participations in commitments, that are conveyed to other U.S. depository institutions or foreign banks.

 $^{^{16}\,\}mathrm{All}$ other bullion holdings are to be assigned to the 100 percent risk weight category.

U.S. depository institutions ²¹ and foreign banks; ²² portions of claims collateralized by cash held in a segregated deposit account of the lending bank; cash items in process of collection, both foreign and domestic; and long-term claims on, and portions of long-term claims guaranteed by, U.S. depository institutions and OECD banks. ²³

b. This category also includes claims on, or portions of claims guaranteed by, U.S. Government-sponsored agencies;²⁴ and portions of

²¹U.S. depository institutions are defined to include branches (foreign and domestic) of federally-insured banks and depository institutions chartered and headquartered in the 50 states of the United States, the District of Columbia, Puerto Rico, and U.S. territories and possessions. The definition encompasses banks, mutual or stock savings banks, savings or building and loan associations, cooperative banks, credit unions, international banking facilities of domestic depository institutions, and U.S.-chartered depository institutions owned by foreigners. However, this definition excludes branches and agencies of foreign banks located in the U.S. and bank holding companies.

22 Foreign banks are distinguished as either OECD banks or non-OECD banks. OECD banks include banks and their branches (foreign and domestic) organized under the laws of countries (other than the U.S.) that belong to the OECD-based group of countries. Non-OECD banks include banks and their branches (foreign and domestic) organized under the laws of countries that do not belong to the OECD-based group of countries. For risk-based capital purposes, a bank is defined as an institution that engages in the business of banking; is recognized as a bank by the bank supervisory or monetary authorities of the country of its organization or principal banking operations; receives deposits to a substantial extent in the regular course of business; and has the power to accept demand deposits.

²³Long-term claims on, or guaranteed by, non-OECD banks and all claims on bank holding companies are assigned to the 100 percent risk weight category, as are holdings of bank-issued securities that qualify as capital of the issuing banks for risk-based capital purposes.

²⁴ For risk-based capital purposes, U.S. Government-sponsored agencies are defined as agencies originally established or chartered by the U.S. Government to serve public purposes specified by the U.S. Congress but whose debt obligations are not explicitly guaranteed by the full faith and credit of the U.S. Government. These agencies include the Federal Home Loan Mortgage Corporation (FHLMC), the Federal National Mortgage Association (FNMA), the Farm Credit System, the Federal Home Loan Bank System,

claims (including repurchase agreements) collateralized by securities issued or guaranteed by OECD central governments, U.S. Government agencies, or U.S. Governmentsponsored agencies. Also included in the 20 percent risk category are portions of claims that are conditionally guaranteed by OECD central governments and U.S. Government agencies, 25 as well as portions of local currency claims that are conditionally guaranteed by non-OECD central governments to the extent that the bank has liabilities booked in that currency.

c. General obligation claims on, or portions of claims guaranteed by, the full faith and credit of states or other political subdivisions of the United States or other countries of the OECD-based group are also assigned to this 20 percent risk category.26 In addition, this category includes claims on the International Bank for Reconstruction and Development (World Bank), national Finance Corporation the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the European Investment Bank, the European Bank for Reconstruction and Development, the Nordic Investment Bank, and other multilateral lending institutions or regional development institutions in which the U.S. Government is a shareholder or contributing member, as well as portions of claims guaranteed by such organizations collateralized by their securities.

d. This category also includes recourse obligations, direct credit substitutes, residual interests (other than a credit-enhancing interest-only strip) and asset- or mortgage-backed securities rated in the highest or second highest investment grade category, e.g., AAA, AA, in the case of long-term ratings, or the highest rating category, e.g., A-1, P-1, in the case of short-term ratings.

and the Student Loan Marketing Association (SLMA). For risk-based capital purposes, claims on U.S. Government-sponsored agencies also include capital stock in a Federal Home Loan Bank that is held as a condition of membership in that Bank.

²⁵ For risk-based capital purposes, a conditional guarantee is deemed to exist if the validity of the guarantee by the OECD central government or the U.S. Government agency is dependent upon some affirmative action (e.g., servicing requirements on the part of the beneficiary of the guarantee). Portions of claims that are unconditionally guaranteed by OECD central governments or U.S. Government agencies are assigned to the zero percent risk category.

²⁶Claims on, or guaranteed by, states or other political subdivisions of countries that do not belong to the OECD-based group of countries are to be placed in the 100 percent risk weight category.

a. Category 3-50 Percent Risk Weight. This category includes loans fully secured by first liens 27 on one-to-four family residential properties, provided that such loans have been approved in accordance with prudent underwriting standards, including standards relating to the loan amount as a percent of the appraised value of the property,28 and provided that the loans are not past due 90 days or more or carried in nonaccrual status.29 The types of loans that qualify as loans secured by one-to-four family residential properties are listed in the instructions for preparation of the Consolidated Reports of Condition and Income. These properties may be either owner-occupied or rented. In addition, for risk-based capital purposes, loans secured by one-to-four family residential properties include loans to builders with substantial project equity for the construction of one-tofour family residences that have been presold under firm contracts to purchasers who have obtained firm commitments for permanent qualifying mortgage loans and have made substantial earnest money deposits. Such loans to builders will be considered prudently underwritten only if the bank has obtained sufficient documentation that the buyer of the home intends to purchase the home (i.e., has a legally binding written sales contract) and has the ability to obtain a mortgage loan sufficient to purchase the home (i.e., has a firm written commitment for permanent financing of the home upon completion), provided the following criteria are met:

(1) The purchaser is an individual(s) who intends to occupy the residence and is not a partnership, joint venture, trust, corporation, or any other entity (including an entity acting as a sole proprietorship) that is purchasing one or more of the homes for speculative purposes;

(2) The builder must incur at least the first ten percent of the direct costs (i.e., actual costs of the land, labor, and material) before any drawdown is made under the construction loan and the construction loan may not exceed 80 percent of the sales price of the presold home;

- (3) The purchaser has made a substantial "earnest money deposit" of no less than three percent of the sales price of the home and the deposit must be subject to forfeiture if the purchaser terminates the sales contract; and
- (4) The earnest money deposit must be held in escrow by the bank financing the builder or by an independent party in a fiduciary capacity and the escrow agreement must provide that, in the event of default arising from the cancellation of the sales contract by the buyer, the escrow funds must first be used to defray any costs incurred by the bank.

By order of the Board of Directors.

- b. This category also includes loans fully secured by first liens on multifamily residential properties,³⁰ provided that:
- (1) The loan amount does not exceed 80 percent of the value 31 of the property securing the loan as determined by the most current appraisal or evaluation, whichever may be appropriate (75 percent if the interest rate on the loan changes over the term of the loan):
- (2) For the property's most recent fiscal year, the ratio of annual net operating income generated by the property (before payment of any debt service on the loan) to annual debt service on the loan is not less than 120 percent (115 percent if the interest rate on the loan changes over the term of the loan) or, in the case of a property owned by a cooperative housing corporation or non-profit organization, the property generates

³¹At the origination of a loan to purchase an existing property, the term "value" means the lesser of the actual acquisition cost or the estimate of value set forth in an appraisal or evaluation, whichever may be appropriate.

²⁷If a bank holds the first and junior lien(s) on a residential property and no other party holds an intervening lien, the transactions are treated as a single loan secured by a first lien for purposes of determining the loan-to-value ratio and assigning a risk weight.

²⁸ For risk-based capital purposes, the loan-to-value ratio generally is based upon the most current appraised value of the property. The appraisal should be performed in a manner consistent with the Federal banking agencies' real estate appraisal guidelines and with the bank's own appraisal guidelines.

²⁹Real estate loans that do not meet all of the specified criteria or that are made for the purpose of property development are placed in the 100 percent risk category.

³⁰ The types of loans that qualify as loans secured by multifamily residential properties are listed in the instructions for preparation of the Consolidated Reports of Condition and Income. In addition, from the standpoint of the selling bank, when a multifamily residential property loan is sold subject to a pro rata loss sharing arrangement which provides for the purchaser of the loan to share in any loss incurred on the loan on a pro rata basis with the selling bank, that portion of the loan is not subject to the riskbased capital standards. In connection with sales of multifamily residential property loans in which the purchaser of the loan shares in any loss incurred on the loan with the selling bank on other than a pro rata basis, the selling bank must treat these other loss sharing arrangements in accordance with section II.B.5 of this appendix A.

sufficient cash flow to provide comparable protection to the bank;

- (3) Amortization of principal and interest on the loan occurs over a period of not more than 30 years;
- (4) The minimum original maturity for repayment of principal on the loan is not less than seven years;
- (5) All principal and interest payments have been made on a timely basis in accordance with the terms of the loan for at least one year before the loan is placed in this category; ³²
- (6) The loan is not 90 days or more past due or carried in nonaccrual status; and
- (7) The loan has been made in accordance with prudent underwriting standards.
- c. This category also includes revenue (nongeneral obligation) bonds or similar obligations, including loans and leases, that are obligations of states or political subdivisions of the United States or other OECD countries, but for which the government entity is committed to repay the debt with revenues from the specific projects financed, rather than from general tax funds (e.g., municipal revenue bonds). In addition, the credit equivalent amount of derivative contracts that do not qualify for a lower risk weight are assigned to the 50 percent risk category.
- d. This category also includes recourse obligations, direct credit substitutes, residual interests (other than a credit-enhancing interest-only strip) and asset- or mortgage-backed securities rated in the third highest investment grade category, e.g., A, in the case of long-term ratings, or the second highest rating category, e.g., A-2, P-2, in the case of short-term ratings.

Category 4—100 Percent Risk Weight. (a) All assets not included in the categories above in section II.C of this appendix A, except the assets specifically included in the 200 percent category below in section II.C of this appendix A and assets that are otherwise risk weighted in accordance with section II.B.5 of this appendix A, are assigned to this category, which comprises standard risk assets. The bulk of the assets typically found in a loan portfolio would be assigned to the 100 percent category.

- (b) This category includes:
- (1) Long-term claims on, and the portions of long-term claims that are guaranteed by, non-OECD banks, and all claims on non-

OECD central governments that entail some degree of transfer risk; 33

- (2) All claims on foreign and domestic private-sector obligors not included in the categories above in section II.C of this appendix A (including loans to nondepository financial institutions and bank holding companies):
- (3) Claims on commercial firms owned by the public sector;
- (4) Customer liabilities to the bank on acceptances outstanding involving standard risk claims; 34
- (5) Investments in fixed assets, premises, and other real estate owned;
- (6) Common and preferred stock of corporations, including stock acquired for debts previously contracted;
- (7) Commercial and consumer loans (except those assigned to lower risk categories due to recognized guarantees or collateral and loans secured by residential property that qualify for a lower risk weight);
- (8) Recourse obligations, direct credit substitutes, residual interests (other than a credit-enhancing interest-only strip) and asset-or mortgage-backed securities rated in the lowest investment grade category, e.g., BBB, as well as certain positions (but not residual interests) which the bank rates pursuant to section section II.B.5(g) of this appendix A.:
- (9) Industrial-development bonds and similar obligations issued under the auspices of states or political subdivisions of the OECD-based group of countries for the benefit of a private party or enterprise where that party or enterprise, not the government entity, is obligated to pay the principal and interest:
- (10) All obligations of states or political subdivisions of countries that do not belong to the OECD-based group; and
- (11) Stripped mortgage-backed securities and similar instruments, such as interest-only strips that are not credit-enhancing and principal-only strips.

³²In the case where the existing owner of a multifamily residential property refinances a loan on that property, all principal and interest payments on the loan being refinanced must have been made on a timely basis in accordance with the terms of that loan for at least the preceding year. The new loan must meet all of the other eligibility criteria in order to qualify for a 50 percent risk weight.

³³ Such assets include all non-local currency claims on, and the portions of claims that are guaranteed by, non-OECD central governments and those portions of local currency claims on, or guaranteed by, non-OECD central governments that exceed the local currency liabilities held by the bank.

³⁴Customer liabilities on acceptances outstanding involving nonstandard risk claims, such as claims on U.S. depository institutions, are assigned to the risk category appropriate to the identity of the obligor or, if relevant, the nature of the collateral or guarantees backing the claims. Portions of acceptances conveyed as risk participations to U.S. depository institutions or foreign banks are assigned to the 20 percent risk category appropriate to short-term claims guaranteed by U.S. depository institutions and foreign banks.

(c) The following assets also are assigned a risk weight of 100 percent if they have not already been deducted from capital: investments in unconsolidated companies, joint ventures, or associated companies; instruments that qualify as capital issued by other banks; deferred tax assets; and mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships. Category 5—200 Percent Risk Weight. This

Category 5—200 Percent Risk Weight. This category includes:

(a) Externally rated recourse obligations, direct credit substitutes, residual interests (other than a credit-enhancing interest-only strip), and asset- and mortgage-backed securities that are rated one category below the lowest investment grade category, e.g., BB, to the extent permitted in section II.B.5(d) of this appendix A: and

(b) A position (but not a residual interest) in a securitization or structured finance program that is not rated by an NRSRO for which the bank determines that the credit risk is equivalent to one category below investment grade, e.g., BB, to the extent permitted in section II.B.5.(g) of this appendix A

D. Conversion Factors for Off-Balance Sheet Items (see Table III)

The face amount of an off-balance sheet item is generally incorporated into the risk-weighted assets in two steps. The face amount is first multiplied by a credit conversion factor, except as otherwise specified in section II.B.5 of this appendix A for direct credit substitutes and recourse obligations. The resultant credit equivalent amount is assigned to the appropriate risk category according to the obligor or, if relevant, the guarantor or the nature of the collateral. Table III to this appendix A sets forth the conversion factors for various types of off-balance-sheet items.

1. Items With a 100 Percent Conversion Factor. (a) Except as otherwise provided in section II.B.5. of this appendix A, the full amount of an asset or transaction supported, in whole or in part, by a direct credit substitute or a recourse obligation. Direct credit substitutes and recourse obligations are defined in section II.B.5. of this appendix A.

(b) Sale and repurchase agreements, if not already included on the balance sheet, and

forward agreements. Forward agreements are legally binding contractual obligations to purchase assets with drawdown which is certain at a specified future date. Such obligations include forward purchases, forward forward deposits placed. ³⁶ and partly-paid shares and securities; they do not include commitments to make residential mortgage loans or forward foreign exchange contracts.

(c) Securities lent by a bank are treated in one of two ways, depending upon whether the lender is exposed to risk of loss. If a bank, as agent for a customer, lends the customer's securities and does not indemnify the customer against loss, then the securities transaction is excluded from the risk-based capital calculation. On the other hand, if a bank lends its own securities or, acting as agent for a customer, lends the customer's securities and indemnifies the customer against loss, the transaction is converted at 100 percent and assigned to the risk weight category appropriate to the obligor or, if applicable, to the collateral delivered to the lending bank or the independent custodian acting on the lending bank's behalf.

2. Items With a 50 Percent Conversion Factor. Transaction-related contingencies are to be converted at 50 percent. Such contingencies include bid bonds, performance bonds, warranties, and performance standby letters of credit related to particular transactions, as well as acquisitions of risk participations in performance standby letters of credits. Performance standby letters of credit (performance bonds) are irrevocable obligations of the bank to pay a third-party beneficiary when a customer (account party) fails to perform on some contractual nonfinancial obligation. Thus, performance standby letters of credit represent obligations backing the performance of nonfinancial or commercial contracts or undertakings. To the extent permitted by law or regulation, performance standby letters of credit include arrangements backing, among other things, subcontractors' and suppliers' performance, labor and materials contracts, and construc-

The unused portion of commitments with an original maturity exceeding one year, including underwriting commitments and commercial and consumer credit commitments, also are to be converted at 50 percent. Original maturity is defined as the length of time between the date the commitment is issued and the earliest date on which: (1) The bank can at its option, unconditionally (without cause) cancel the commitment, 37 and (2) the

³⁵The sufficiency of collateral and guarantees for off-balance-sheet items is determined by the market value of the collateral or the amount of the guarantee in relation to the face amount of the item, except for derivative contracts, for which this determination is generally made in relation to the credit equivalent amount. Collateral and guarantees are subject to the same provisions noted under section II.B. of this appendix A.

 $^{^{36} \, \}mathrm{Forward}$ forward deposits accepted are treated as interest rate contracts.

³⁷In the case of home equity or mortgage lines of credit secured by liens on one-to-four family residential properties, a bank is Continued

bank is scheduled to (and as a normal practice actually does) review the facility to determine whether or not it should be extended and, on at least an annual basis, continues to regularly review the facility. Facilities that are unconditionally cancelable (without cause) at any time by the bank are not deemed to be commitments, provided the bank makes a separate credit decision before each drawing under the facility.

Commitments, for risk-based capital purposes, are defined as any arrangements that obligate a bank to extend credit in the form of loans or lease financing receivables; to purchase loans, securities, or other assets; or to participate in loans and leases. Commitments also include overdraft facilities, revolving credit, home equity and mortgage lines of credit, and similar transactions. Normally, commitments involve a written contract or agreement and a commitment fee, or some other form of consideration. Commitments are included in risk-weighted assets regardless of whether they contain material adverse change clauses or other provisions that are intended to relieve the issuer of its funding obligation under certain conditions.

In the case of commitments structured as syndications where the bank is obligated only for its pro rata share, the risk-based capital framework includes only the bank's proportional share of such commitments. Thus, after a commitment has been converted at 50 percent, portions of commitments that have been conveved to other U.S. depository institutions or OECD banks, but for which the originating bank retains the full obligation to the borrower if the participating bank fails to pay when the commitment is drawn upon, will be assigned to the 20 risk category. The acquisition of such a participation in a commitment would be converted at 50 percent and the credit equivalent amount would be assigned to the risk category that is appropriate for the account party obligor or, if relevant, to the nature of the collateral or guarantees

Revolving underwriting facilities (RUFs), note issuance facilities (NIFs), and other similar arrangements also are converted at 50 percent. These are facilities under which a borrower can issue on a revolving basis short-term notes in its own name, but for which the underwriting banks have a legally binding commitment either to purchase any notes the borrower is unable to sell by the rollover date or to advance funds to the borrower

deemed able to unconditionally cancel the commitment if, at its option, it can prohibit additional extensions of credit, reduce the credit line, and terminate the commitment to the full extent permitted by relevant Federal law

- 3. Items With a 20 Percent Conversion Factor. Short-term, self-liquidating, trade-related contingencies which arise from the movement of goods are converted at 20 percent. Such contingencies include commercial letters of credit and other documentary letters of credit collateralized by the underlying shipments.
- 4. Items With a Zero Percent Conversion Factor. These include unused portions of commitments with an original maturity of one year or less, or which are unconditionally cancellable at any time (provided a separate credit decision is made before each drawing under the facility). Unused portions of retail credit card lines and related plans are deemed to be short-term commitments if the bank, in accordance with applicable law, has the unconditional option to cancel the credit line at any time.
- E. Derivative Contracts (Interest Rate, Exchange Rate, Commodity (including precious metal) and Equity Derivative Contracts)
- 1. Credit equivalent amounts are computed for each of the following off-balance-sheet derivative contracts:
 - (a) Interest Rate Contracts
 - (i) Single currency interest rate swaps.
 - (ii) Basis swaps.
 - (iii) Forward rate agreements.
- (iv) Interest rate options purchased (including caps, collars, and floors purchased).
- (v) Any other instrument linked to interest rates that gives rise to similar credit risks (including when-issued securities and forward deposits accepted).
- (b) Exchange Rate Contracts
- (i) Cross-currency interest rate swaps.
- (ii) Forward foreign exchange contracts.
- (iii) Currency options purchased.
- (iv) Any other instrument linked to exchange rates that gives rise to similar credit risks.
- (c) Commodity (including precious metal) or Equity Derivative Contracts
 - (i) Commodity- or equity-linked swaps.
- (ii) Commodity- or equity-linked options purchased.
- (iii) Forward commodity- or equity-linked contracts.
- (iv) Any other instrument linked to commodities or equities that gives rise to similar credit risks.
- 2. Exchange rate contracts with an original maturity of 14 calendar days or less and derivative contracts traded on exchanges that require daily receipt and payment of cash variation margin may be excluded from the risk-based ratio calculation. Gold contracts are accorded the same treatment as exchange rate contracts except gold contracts with an original maturity of 14 calendar days or less are included in the risk-based calculation. Over-the-counter options purchased are included and treated in the same way as other derivative contracts.

- 3. Credit Equivalent Amounts for Derivative Contracts. (a) The credit equivalent amount of a derivative contract that is not subject to a qualifying bilateral netting contract in accordance with section II.E.5. of this appendix A is equal to the sum of:
- (i) The current exposure (which is equal to the mark-to-market value, 38 if positive, and is sometimes referred to as the replacement cost) of the contract; and
- (ii) An estimate of the potential future credit exposure.
- (b) The current exposure is determined by the mark-to-market value of the contract. If

the mark-to-market value is positive, then the current exposure is equal to that markto-market value. If the mark-to-market value is zero or negative, then the current exposure is zero.

(c) The potential future credit exposure of a contract, including a contract with a negative mark-to-market value, is estimated by multiplying the notional principal amount of the contract by a credit conversion factor. Banks should, subject to examiner review, use the effective rather than the apparent or stated notional amount in this calculation. The credit conversion factors are:

CONVERSION FACTOR MATRIX

Remaining maturity	Interest rate	Exchange rate and gold	Equity	Precious metals, ex- cept gold	Other com- modities
One year or less More than one year to five years More than five years	0.0%	1.0%	6.0%	7.0%	10.0%
	0.5%	5.0%	8.0%	7.0%	12.0%
	1.5%	7.5%	10.0%	8.0%	15.0%

- (d) For contracts that are structured to settle outstanding exposure on specified dates and where the terms are reset such that the market value of the contract is zero on these specified dates, the remaining maturity is equal to the time until the next reset date. For interest rate contracts with remaining maturities of more than one year and that meet these criteria, the conversion factor is subject to a minimum value of 0.5 percent.
- (e) For contracts with multiple exchanges of principal, the conversion factors are to be multiplied by the number of remaining payments in the contract. Derivative contracts not explicitly covered by any of the columns of the conversion factor matrix are to be treated as "other commodities."
- (f) No potential future exposure is calculated for single currency interest rate swaps in which payments are made based upon two floating rate indices (so called floating/floating or basis swaps); the credit exposure on these contracts is evaluated solely on the basis of their mark-to-market values.
- 4. Risk Weights and Avoidance of Double Counting. (a) Once the credit equivalent amount for a derivative contract, or a group of derivative contracts subject to a qualifying bilateral netting agreement, has been determined, that amount is assigned to the risk category appropriate to the counterparty, or, if relevant, the guarantor or the nature of any collateral. However, the maximum weight that will be applied to the

- credit equivalent amount of such contracts is 50 percent.
- (b) In certain cases, credit exposures arising from the derivative contracts covered by these guidelines may already be reflected, in part, on the balance sheet. To avoid double counting such exposures in the assessment of capital adequacy and, perhaps, assigning inappropriate risk weights, counterparty credit exposures arising from the types of instruments covered by these guidelines may need to be excluded from balance sheet assets in calculating a bank's risk-based capital ratio.
- (c) The FDIC notes that the conversion factors set forth in section II.E.3. of appendix A, which are based on observed volatilities of the particular types of instruments, are subject to review and modification in light of changing volatilities or market conditions.
- (d) Examples of the calculation of credit equivalent amounts for these types of contracts are contained in Table IV of this appendix A.
- 5. Netting. (a) For purposes of this appendix A, netting refers to the offsetting of positive and negative mark-to-market values when determining a current exposure to be used in the calculation of a credit equivalent amount. Any legally enforceable form of bilateral netting (that is, netting with a single counterparty) of derivative contracts is recognized for purposes of calculating the credit equivalent amount provided that:
- (i) The netting is accomplished under a written netting contract that creates a single legal obligation, covering all included individual contracts, with the effect that the

reflect changes in both underlying rates, prices and indices, and counterparty credit quality.

 $^{^{38}\,\}mathrm{Mark}\text{-to-market}$ values are measured in dollars, regardless of the currency or currencies specified in the contract and should

bank would have a claim or obligation to receive or pay, respectively, only the net amount of the sum of the positive and negative mark-to-market values on included individual contracts in the event that a counterparty, or a counterparty to whom the contract has been validly assigned, fails to perform due to default, bankruptcy, liquidation, or similar circumstances;

- (ii) The bank obtains a written and reasoned legal opinion(s) representing that in the event of a legal challenge, including one resulting from default, insolvency, bankruptcy or similar circumstances, the relevant court and administrative authorities would find the bank's exposure to be such a net amount under:
- (1) The law of the jurisdiction in which the counterparty is chartered or the equivalent location in the case of noncorporate entities and, if a branch of the counterparty is involved, then also under the law of the jurisdiction in which the branch is located;
- (2) The law that governs the individual contracts covered by the netting contract; and
- (3) The law that governs the netting contract.
- (iii) The bank establishes and maintains procedures to ensure that the legal characteristics of netting contracts are kept under review in the light of possible changes in relevant law; and
- (iv) The bank maintains in its file documentation adequate to support the netting of derivative contracts, including a copy of the bilateral netting contract and necessary legal opinions.
- (b) A contract containing a walkaway clause is not eligible for netting for purposes of calculating the credit equivalent amount.³⁹
- (c) By netting individual contracts for the purpose of calculating its credit equivalent amount, a bank represents that it has met the requirements of this appendix A and all the appropriate documents are in the bank's files and available for inspection by the FDIC. Upon determination by the FDIC that a bank's files are inadequate or that a netting contract may not be legally enforceable under any one of the bodies of law described in paragraphs (ii)(1) through (3) of section II.E.5.(a) of this appendix A, underlying individual contracts may be treated as though

they were not subject to the netting contract.

- (d) The credit equivalent amount of derivative contracts that are subject to a qualifying bilateral netting contract is calculated by adding:
- (i) The net current exposure of the netting contract; and
- (ii) The sum of the estimates of potential future exposure for all individual contracts subject to the netting contract, adjusted to take into account the effects of the netting contract. 40
- (e) The net current exposure is the sum of all positive and negative mark-to-market values of the individual contracts subject to the netting contract. If the net sum of the mark-to-market values is positive, then the net current exposure is equal to that sum. If the net sum of the mark-to-market values is zero or negative, then the net current exposure is zero.
- (f) The effects of the bilateral netting contract on the gross potential future exposure are recognized through application of a formula, resulting in an adjusted add-on amount ($A_{\rm net}$). The formula, which employs the ratio of net current exposure to gross current exposure (NGR) is expressed as:

$$A_{net} = (0.4 \times A_{gross}) + 0.6(NGR \times A_{gross})$$

The effect of this formula is that A_{net} is the weighted average of A_{gross} , and A_{gross} adjusted by the NGR.

- (g) The NGR may be calculated in either one of two ways—referred to as the counterparty-by-counterparty approach and the aggregate approach.
- (i) Under the counterparty-by-counterparty approach, the NGR is the ratio of the net current exposure of the netting contract to the gross current exposure of the netting contract. The gross current exposure is the sum of the current exposures of all individual contracts subject to the netting contract calculated in accordance with section II.E. of this appendix A.
- (ii) Under the aggregate approach, the NGR is the ratio of the sum of all of the net current exposures for qualifying bilateral netting contracts to the sum of all of the gross current exposures for those netting contracts (each gross current exposure is calculated in the same manner as in section II.E.5.(g)(i) of this appendix A). Net negative mark-to-market values to individual counterparties cannot be used to offset net

³⁹ For purposes of this section, a walkaway clause means a provision in a netting contract that permits a non-defaulting counterparty to make lower payments than it would make otherwise under the contract, or no payment at all, to a defaulter or to the estate of a defaulter, even if a defaulter or the estate of a defaulter is a net creditor under the contract.

⁴⁰ For purposes of calculating potential future credit exposure for foreign exchange contracts and other similar contracts in which notional principal is equivalent to cash flows, total notional principal is defined as the net receipts to each party falling due on each value date in each currency.

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positive current other exposures to counterparties.

(iii) A bank must use consistently either the counterparty-by-counterparty approach or the aggregate approach to calculate the NGR. Regardless of the approach used, the NGR should be applied individually to each qualifying bilateral netting contract to determine the adjusted add-on for that netting contract.

III. Minimum Risk-Based Capital Ratio

Subject to section II.B.5. of this appendix A, banks generally will be expected to meet a minimum ratio of qualifying total capital

to risk-weighted assets of 8 percent, of which at least 4 percentage points should be in the form of core capital (Tier 1). Any bank that does not meet the minimum risk-based capital ratio, or whose capital is otherwise considered inadequate, generally will be expected to develop and implement a capital plan for achieving an adequate level of capital, consistent with the provisions of this risk-based capital framework and §325.104, the specific circumstances affecting the individual bank, and the requirements of any related agreements between the bank and the FDIC.

TABLE I.—DEFINITION OF QUALIFYING CAPITAL

Components	Minimum requirements
(1) Core Capital (Tier 1)	Must equal or exceed 4% of weighted-risk assets.
(a) Common stockholders' equity	No limit.1
(b)Noncumulative perpetual preferred stock and any related surplus.	No limit. ¹
(c) Minority interest in equity accounts of consolidated	No limit.1
(d) Less: All intangible assets other than certain mortgage servicing assets, nonmortgage servicing assets and pur- chased credit card relationships.	(2).
(e) Less: Certain credit-enhancing interest-only strips	(3).
(f) Less: Certain deferred tax assets	(4).
(2) Supplementary Capital (Tier 2)	Total of tier 2 is limited to 100% of tier 1.5
(a) Allowance for loan and lease losses	Limited to 1.25% of weighted-risk assets. ⁵
Limited to 45% of pretax net unrealized gains. ⁶ . (c) Cumulative perpetual and long-term preferred stock	No limit within the 2. long town professed in apportional for our
(original maturity of 20 years or more) and any related surplus.	No limit within tier 2; long-term preferred is amortized for capital purposes as it approaches maturity.
 (d) Auction rate and similar preferred stock (both cumulative and non-cumulative). 	No limit within Tier 2.
(e) Hybrid capital instruments (including mandatory convertible debt securities).	No limit within Tier 2.
(f) Term subordinated debt and intermediate-term pre- ferred stock (original weighted average maturity of five years or more).	Term subordinated debt and intermediate-term preferred stock are limited to 50% of Tier 1 ⁵ and amortized for capital purposes as they approach maturity.
(3) Deductions (from sum of tier 1 and tier 2):	
(a) Investments in banking and finance subsidiaries that	
are not consolidated for regulatory capital purposes.	
(b) Intentional, reciprocal cross-holdings of capital securi- ties issued by banks.	
(c) Other deductions (such as investment in other subsidi- aries or joint ventures) as determined by supervisory au- thority.	On a case-by-case basis or as a matter of policy after formal consideration of relevant issues.
(4) Total Capital	Must equal or exceed 8% or weighted-risk assets.

¹ No express limits are placed on the amounts of nonvoting common, noncumulative perpetual preferred stock, and minority interests that may be recognized as part of Tier 1 capital. However, voting common stockholders' equity capital generally will be expected to be the dominant form of Tier 1 capital and banks should avoid undue reliance on other Tier 1 capital elements.

2 The amounts of mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships that can be recognized for purposes of calculating Tier 1 capital are subject to the limitations set forth in § 325.5(f). All deductions are for capital purposes only; deductions would not affect accounting treatment.

3 The amounts of credit-enhancing interest-only strips that can be recognized for purposes of calculating Tier 1 capital are subject to the limitations set forth in § 325.5(f).

4 Deferred tax assets are subject to the capital limitations set forth in § 325.5(g).

5 Amounts in excess of limitations are permitted but do not qualify as capital.

CALCULATION OF THE RISK-BASED CAPITAL RATIO

When calculating the risk-based capital ratio under the framework set forth in this statement of policy, qualifying total capital (the numerator) is divided by risk-weighted assets (the denominator). The process of determining the numerator for the ratio is summarized in Table I. The calculation of the denominator is based on the risk weights

⁵ Amounts in excess of limitations are permitted but do not qualify as capital. ⁶ Unrealized gains on equity securities are subject to the capital limitations set forth in paragraph I.A2.(f) of appendix A to part 325

and conversion factors that are summarized in Tables II and III.

When determining the amount of risk-weighted assets, balance sheet assets are assigned an appropriate risk weight (see Table II) and off-balance sheet items are first converted to a credit equivalent amount (see Table III) and then assigned to one of the risk weight categories set forth in Table II.

The balance sheet assets and the credit equivalent amount of off-balance sheet items are then multiplied by the appropriate risk weight percentages and the sum of these risk-weighted amounts is the gross risk-weighted asset figure used in determining the denominator of the risk-based capital ratio. Any items deducted from capital when computing the amount of qualifying capital may also be excluded from risk-weighted assets when calculating the denominator for the risk-based capital ratio.

TABLE II.—SUMMARY OF RISK WEIGHTS AND RISK CATEGORIES

Category 1—Zero Percent Risk Weight

- (1) Cash (domestic and foreign).
- (2) Balances due from Federal Reserve Banks and central banks in other OECD countries.
- (3) Direct claims on, and portions of claims unconditionally guaranteed by, the U.S. Treasury, U.S. Government agencies, or central governments in other OECD countries.
- (4) Portions of local currency claims on, or unconditionally guaranteed by, non-OECD central governments (including non-OECD central banks), to the extent the bank has liabilities booked in that currency.
- (5) Gold bullion held in the bank's own vaults or in another bank's vaults on an allocated basis, to the extent that it is offset by gold bullion liabilities
- (6) Federal Reserve Bank stock.

Category 2—20 Percent Risk Weight

- (1) Cash items in the process of collection.(2) All claims (long- and short-term) on, and portions of claims (long- and short-term)
- and portions of claims (long- and short-term) guaranteed by, U.S. depository institutions and OECD banks.
- (3) Short-term (remaining maturity of one year or less) claims on, and portions of short-term claims guaranteed by, non-OECD banks.
- ¹For the purpose of calculating the risk-based capital ratio, a U.S. Government agency is defined as an instrumentality of the U.S. Government whose obligations are fully and explicitly guaranteed as to the timely repayment of principal and interest by the full faith and credit of the U.S. Government.

- (4) Portions of loans and other claims conditionally guaranteed by the U.S. Treasury, U.S. Government agencies, or central governments in other OECD countries and portions of local currency claims conditionally guaranteed by non-OECD central governments to the extent that the bank has liabilities booked in that currency.
- (5) Securities and other claims on, and portions of claims guaranteed by, U.S. Government-sponsored agencies.²
- (6) Portions of loans and other claims (including repurchase agreements) collateralized by securities issued or guaranteed by the U.S. Treasury, U.S. Government agencies, U.S. Government-sponsored agencies or central governments in other OECD countries.
- (7) Portions of loans and other claims collateralized³ by cash on deposit in the lending bank.
- (8) General obligation claims on, and portions of claims guaranteed by, the full faith and credit of states or other political subdivisions of OECD countries, including U.S. state and local governments.
- (9) Claims on, and portions of claims guaranteed by, official multilateral lending institutions or regional development institutions in which the U.S. Government is a shareholder or a contributing member.
- (10) Portions of claims collateralized³ by securities issued by official multilateral lending institutions or regional development institutions in which the U.S. Government is a shareholder or contributing member.
- (11) Investments in shares of mutual funds whose portfolios are permitted to hold only assets that qualify for the zero or 20 percent risk categories.
- (12) Recourse obligations, direct credit substitutes, residual interests (other than credit-enhancing interest-only strips) and assetor mortgage-backed securities rated in either of the two highest investment grade categories, e.g., AAA or AA, in the case of long-term ratings, or the highest rating category, e.g., A-1, P-1, in the case of short-term ratings.

²For the purpose of calculating the risk-based capital ratio, a U.S. Government-sponsored agency is defined as an agency originally established or chartered to serve public purposes specified by the U.S. Congress but whose obligations are not explicitly guaranteed by the full faith and credit of the U.S. Government.

³Degree of collateralization is determined by current market value.

Category 3-50 Percent Risk Weight

- (1) Loans fully secured by first liens on one-to-four family residential properties (including certain presold residential construction loans), provided that the loans were approved in accordance with prudent underwriting standards and are not past due 90 days or more or carried in nonaccrual status.
- (2) Loans fully secured by first liens on multifamily residential properties that have been prudently underwritten and meet specified requirements with respect to loan-to-value ratio, level of annual net operating income to required debt service, maximum amortization period, minimum original maturity, and demonstrated timely repayment performance.
- (3) Recourse obligations, direct credit substitutes, residual interests (other than credit-enhancing interest-only strips) and asset-or mortgage-backed securities rated in the third-highest investment grade category, e.g., A, in the case of long-term ratings, or the second highest rating category, e.g., A-2, P-2, in the case of short-term ratings.
- (4) Revenue bonds or similar obligations, including loans and leases, that are obligations of U.S. state or political subdivisions of the United States or other OECD countries but for which the government entity is committed to repay the debt only out of revenues from the specific projects financed.
- (5) Credit equivalent amounts of interest rate and foreign exchange rate related contracts, except for those assigned to a lower risk category.

Category 4-100 Percent Risk Weight

- (1) All other claims on private obligors.
- (2) Claims on, or guaranteed by, non-OECD banks with a remaining maturity exceeding one year.
- (3) Claims on non-OECD central governments that are not included in item 4 of Category 1 or item 3 of Category 2, and all claims on non-OECD state and local governments.
- (4) Obligations issued by U.S. state or local governments or other OECD local governments (including industrial development authorities and similar entities) that are repayable solely by a private party or enterprise.
- (5) Premises, plant, and equipment; other fixed assets; and other real estate owned.
- (6) Investments in any unconsolidated subsidiaries, joint ventures, or associated companies—if not deducted from capital.
- (7) Instruments issued by other banking organizations that qualify as capital.
- (8) Claims on commercial firms owned by the U.S. Government or foreign governments.
- (9) Recourse obligations, direct credit substitutes, residual interests (other than credit-enhancing interest-only strips) and asset-

or mortgage-backed securities rated in the lowest investment grade category, e.g., BBB, as well as certain positions (but not residual interests) which the bank rates pursuant to section II.B.5(g) of this appendix A.

(10) All other assets, including any intangible assets that are not deducted from capital, and the credit equivalent amounts⁴ of off-balance sheet items not assigned to a different risk category.

Category 5-200 Percent Risk Weight.

- (1) Externally rated recourse obligations, direct credit substitutes, residual interests (other than credit-enhancing interest-only strips), and asset- and mortgage-backed securities that are rated one category below the lowest investment grade category, e.g., BB, to the extent permitted in section II.B.5(d) of this appendix A; and
- (2) A position (but not a residual interest) extended in connection with a securitization or structured financing program that is not rated by an NRSRO for which the bank determines that the credit risk is equivalent to one category below investment grade, e.g., BB, to the extent permitted in section II.B.5.(g) of this appendix A.

TABLE III.—CREDIT CONVERSION FACTORS FOR OFF-BALANCE SHEET ITEMS

100 Percent Conversion Factor

- (1) The full amount of assets supported by direct credit substitutes and recourse obligations (unless a different treatment is otherwise specified). For risk participations in such arrangements acquired by the bank, the full amount of assets supported by the main obligation multiplied by the acquiring bank's percentage share of the risk participation.
- (2) Acquisitions of risk participations in bankers acceptances.
- (3) Sale and repurchase agreements, if not already included on the balance sheet.
- (4) Forward agreements representing contractual obligations to purchase assets, including financing facilities, with drawdown certain at a specified future date.
- (5) Securities lent, if the lending bank is exposed to risk of loss.

50 Percent Conversion Factor

(1) Transaction-related contingencies, including bid bonds, performance bonds, warranties, and performance standby letters of credit backing the nonfinancial performance of other parties.

⁴In general, for each off-balance sheet item, a conversion factor (see Table III) must be applied to determine the "credit equivalent amount" prior to assigning the off-balance sheet item to a risk weight category.

- (2) Unused portions of commitments with an original maturity exceeding one year, including underwriting commitments and commercial credit lines.
- (3) Revolving underwriting facilities (RUFs), note issuance facilities (NIFs) and other similar arrangements.

20 Percent Conversion Factor

(1) Short-term, self-liquidating, trade-related contingencies, including commercial letters of credit.

Zero Percent Conversion Factor

(1) Unused portions of commitments with an original maturity of one year or less.

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(2) Unused portions of commitments (regardless of maturity) which are unconditionally cancelable at any time, provided a separate credit decision is made before each drawing.

Credit Conversion for Interest Rate and Foreign Exchange Rate Related Contracts

The total replacement cost of contracts (obtained by summing the positive mark-to-market values of contracts) is added to a measure of future potential increases in credit exposure. This future potential credit exposure measure is calculated by multiplying the total notional value of contracts by one of the following credit conversion factors, as appropriate:

CONVERSION FACTOR MATRIX

Remaining maturity	Interest rate	Exchange rate and gold	Equity	Precious metals, ex- cept gold	Other com- modities
One year or less More than one year to five years More than five years	0.0%	1.0%	6.0%	7.0%	10.0%
	0.5%	5.0%	8.0%	7.0%	12.0%
	1.5%	7.5%	10.0%	8.0%	15.0%

No potential exposure is calculated for single currency interest rate contracts on which payments are made based on two floating rate indices (floating/floating or basis swaps); the credit exposure on these contracts is evaluated solely on the basis of their mark-to-market values. In the event a netting contract covers transactions that are normally not included in the risk-based ratio calculation—for example, exchange rate contracts with an original maturity of

fourteen calendar days or less or instruments traded on exchanges that require daily payment of variation margin—an institution may elect to consistently either include or exclude all mark-to-market values of such transactions when determining a net current exposure. Multiple contracts with the same counterparty may be netted for risk-based capital purposes pursuant to section II.E.5. of this appendix.

TABLE IV.—CALCULATION OF CREDIT EQUIVALENT AMOUNTS FOR DERIVATIVE CONTRACTS

Potential exposure	+	Current ex-	=	Credit equivalent amount		= Credit equivalen		Credit
Type of contract (remaining maturity)	Notional principal (dollars)	Conversion factor	Potential exposure (dollars)	Mark-to market value	Current ex- posure (dol- lars)	equivalent amount		
(1) 120-Day Forward Foreign Exchange	5,000,000 6,000,000	.01 .05	50,000 300,000	100,000 - 120,000	100,000	150,000 300,000		
ing Interest Rate Swap	10,000,000 10,000,000	.005 .10	50,000 1,000,000	200,000 -250,000	200,000 0	250,000 1,000,000		
Floating Interest Rate Swap	20,000,000	.075	1,500,000 2,900,000	-1,500,000 	0 300,000	1,500,000 3,200,000		

(1) If contracts (1) through (5) above are subject to a qualifying bilateral netting contract, then the following applies:

	Potential fu- ture expo- sure (from above)	Net current exposure*	Credit equivalent amount
(1)	50,000		

	Potential fu- ture expo- sure (from above)		Net current exposure*		Credit equivalent amount
(2)(3)	300,000 50,000				
(4)	1,000,000				
(5)	1,500,000				
Total	2,900,000	+	0	=	2,900,000

^{*}The total of the mark-to-market values from above is -1,370,000. Since this is a negative amount, the net current exposure is 7000.

(2) To recognize the effects of netting on potential future exposure, the following formula applies:

 $A_{net} = (0.4 \times A_{gross}) + 0.6(NGR \times A_{gross})$

(3) In the above example:

NGR=0=(0/300.000)

 A_{net} =(0.4×2,900,000)+0.6(0×2,900,000)

A_{net}=1,160,000

Credit Equivalent Amount: 1 160 000+0=1 160 000

(4) If the net current exposure was a positive amount, for example, \$200,000, the credit equivalent amount would be calculated as follows:

 $\mathbf{NGR} = .67 = (200,000/300,000)$

 $A_{\text{net}} = (0.4 \times 2,900,000) + 0.6(.67 \times 2,900,000)$

 $A_{net} = 2,325,800$

Credit Equivalent Amount: 2,325,800+200,000 = 2,525,800

[54 FR 11509, Mar. 21, 1989]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting Appendix A of part 325, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and on GPO Access.

APPENDIX B TO PART 325—STATEMENT OF POLICY ON CAPITAL ADEQUACY

Part 325 of the Federal Deposit Insurance Corporation rules and regulations (12 CFR part 325) sets forth minimum leverage capital requirements for fundamentally sound, well-managed banks having no material or significant financial weaknesses. It also defines capital and sets forth sanctions which will be used against banks which are in violation of the part 325 regulation. This statement of policy on capital adequacy provides some interpretational and definitional guidance as to how this part 325 regulation will be administered and enforced by the FDIC. This statement of policy also addresses certain aspects of the FDIC's minimum riskbased capital guidelines that are set forth in appendix A to part 325. This statement of policy does not address the prompt corrective action provisions mandated by the Federal Deposit Insurance Corporation Improvement Act of 1991. However, section 38 of the

Federal Deposit Insurance Act and subpart B of part 325 provide guidance on the prompt corrective action provisions, which generally apply to institutions with inadequate levels of capital.

I. ENFORCEMENT OF MINIMUM CAPITAL REQUIREMENTS

Section 325.3(b)(1) specifies that FDIC-supervised, state-chartered nonmember commercial and savings banks (or other insured depository institutions making applications to the FDIC that require the FDIC to consider the adequacy of the institutions' capital structure) must maintain a minimum leverage ratio of Tier 1 (or core) capital to total assets of at least 3 percent; however, this minimum only applies to the most highly-rated banks (i.e., those with a composite CAMELS rating of 1 under the Uniform Financial Institutions Rating System established by the Federal Financial Institutions Examination Council) that are not anticipating or experiencing any significant growth. All other state nonmember banks would need to meet a minimum leverage ratio that is at least 100 to 200 basis points above this minimum. That is, in accordance with §325.3(b)(2), an absolute minimum leverage ratio of not less than 4 percent must be maintained by those banks that are not highly-rated or that are anticipating or experiencing significant growth.

In addition to the minimum leverage capital standards, section III of appendix A to part 325 indicates that state nonmember banks generally are expected to maintain a minimum risk-based capital ratio of qualifying total capital to risk-weighted assets of 8 percent, with at least one-half of that total capital amount consisting of Tier 1 capital.

State nonmember banks (hereinafter referred to as "banks") operating with leverage capital ratios below the minimums set forth in part 325 will be deemed to have inadequate capital and will be in violation of the part 325 regulation. Furthermore, banks operating with risk-based capital ratios below the minimums set forth in appendix A to part 325 generally will be deemed to have inadequate capital. Banks failing to meet the minimum leverage and/or risk-based capital

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ratios normally can expect to have any application submitted to the FDIC denied (if such application requires the FDIC to evaluate the adequacy of the institution's capital structure) and also can expect to be subject to the use of capital directives or other formal enforcement action by the FDIC to increase capital.

Capital adequacy in banks which have capital ratios at or above the minimums will be assessed and enforced based on the following factors (these same criteria will apply to any insured depository institutions making applications to the FDIC and to any other circumstances in which the FDIC is requested or required to evaluate the adequacy of a depository institution's capital structure):

A. Banks Which Are Fundamentally Sound and Well-Managed

The minimum leverage capital ratios set forth in §325.3(b)(2) and the minimum riskbased capital ratios set forth in section III of appendix A to part 325 generally will be viewed as the minimum acceptable capital standards for banks whose overall financial condition is fundamentally sound, which are well-managed and which have no material or significant financial weaknesses. While the FDIC will make this determination in each bank based upon its own condition and specific circumstances, this definition will generally apply to those banks evidencing a level of risk which is no greater than that normally associated with a Composite rating of 1 or 2 under the Uniform Financial Institutions Rating System. Banks meeting this definition which are in compliance with the minimum leverage and risk-based capital ratio standards will not generally be required by the FDIC to raise new capital from external sources.

The FDIC does, however, encourage such banks to maintain capital well above the minimums, particularly those institutions that are anticipating or experiencing significant growth, and will carefully evaluate their earnings and growth trends, dividend policies, capital planning procedures and other factors important to the continuous maintenance of adequate capital. Adverse trends or deficiencies in these areas will be subject to criticism at regular examinations and may be an important factor in the FDIC's action on applications submitted by such banks. In addition, the FDIC's consideration of capital adequacy in banks making applications to the FDIC will also fully examine the expected impact of those applications on the bank's ability to maintain its capital adequacy. In all cases, banks should maintain capital commensurate with the level and nature of risks, including the volume and severity of adversely classified assets, to which they are exposed.

B. All Other Banks

Banks not meeting the definition set forth in I.A. of this appendix, that is, banks evidencing a level of risk which is at least as great as that normally associated with a Composite rating of 3, 4, or 5 under the Uniform Financial Institutions Rating System. will be required to maintain capital higher than the minimum regulatory requirement and at a level deemed appropriate in relation to the degree of risk within the institution. These higher capital levels will normally be addressed through memorandums of understanding between the FDIC and the bank or. in cases of more pronounced risk, through the use of formal enforcement actions under section 8 of the Federal Deposit Insurance Act (12 U.S.C. 1818).

C. Capital Requirements of Primary Regulator

Notwithstanding I.A. and B. of this appendix, all banks (or other depository institutions making applications to the FDIC that require the FDIC to consider the adequacy of the institutions' capital structure) will be expected to meet any capital requirements established by their primary state or federal regulator which exceed the minimum capital requirement set forth in the FDIC's part 325 regulation. In addition, the FDIC will, when establishing capital requirements higher than the minimum set forth in the regulation, consult with an institution's primary state or federal regulator.

II. CAPITAL PLANS

Section 325.4(b) specifies that any bank which has less than its minimum leverage capital requirement is deemed to be engaging in an unsafe or unsound banking practice unless it has submitted, and is in compliance with, a plan approved by the FDIC to increase its Tier 1 leverage capital ratio to such level as the FDIC deems appropriate.

As required under §325.104(a)(1) of this part, a bank must file a written capital restoration plan with the appropriate FDIC regional director within 45 days of the date that the bank receives notice or is deemed to have notice that the bank is undercapitalized, significantly undercapitalized or critically undercapitalized, unless the FDIC notifies the bank in writing that the plan is to be filed within a different period. The amount of time allowed to achieve the minimum leverage capital requirement will be evaluated by the FDIC on a case-by-case basis and will depend on a number of factors, including the viability of the bank and whether it is fundamentally sound and well-managed.

Banks evidencing more than normal levels of risk will normally have their minimum capital requirements established in a formal or informal enforcement proceeding. The time frames for meeting these requirements

will be set forth in such actions and will generally require some immediate action on the bank's part to meet its minimum capital requirement. The reasonableness of capital plans submitted by depository institutions in connection with applications as provided for in §325.3(d)(2) will be determined in conjunction with the FDIC's consideration of the application.

III. WRITTEN AGREEMENTS

Section 325.4(c) provides that any insured depository institution with a Tier 1 capital to total assets (leverage) ratio of less than 2 percent must enter into and be in compliance with a written agreement with the FDIC (or with its primary federal regulator with FDIC as a party to the agreement) to increase its Tier 1 leverage capital ratio to such level as the FDIC deems appropriate or may be subject to a section 8(a) termination of insurance action by the FDIC. Except in the very rarest of circumstances, the FDIC will require that such agreements contemplate immediate efforts by the depository institution to acquire the required capital.

The guidance in this section III is not intended to preclude the FDIC from taking section 8(a) or other enforcement action against any institution, regardless of its capital level, if the specific circumstances deem such action to be appropriate.

IV. CAPITAL COMPONENTS

Section 325.2 sets forth the definition of Tier 1 capital for the leverage standard as well as the definitions for the various instruments and accounts which are included therein. Although nonvoting common stock, noncumulative perpetual preferred stock, and minority interests in consolidated subsidiaries are normally included in Tier 1 capital, voting common stockholders' equity generally will be expected to be the dominant form of Tier 1 capital. Thus, banks should avoid undue reliance on nonvoting equity, preferred stock and minority interests. The following provides some additional guidance with respect to some of the items that affect the calculation of Tier 1 capital.

A. Intangible Assets

The FDIC permits state nonmember banks to record intangible assets on their books and to report the value of such assets in the Consolidated Reports of Condition and Income ("Call Report"). As noted in the instructions for preparation of the Consolidated Reports of Condition and Income (published by the Federal Financial Institutions Examination Council), intangible assets may arise from business combinations accounted for under the purchase method and acquisitions of portions or segments of another institution's business, such as branch offices,

mortgage servicing portfolios, and credit card portfolios.

Notwithstanding the authority to report all intangible assets in the Consolidated Reports of Condition and Income, §325.2(v) of the regulation specifies that mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships are the only intangible assets which will be allowed as Tier 1 capital.1 The portion of equity capital represented by other types of intangible assets will be deducted from equity capital and assets in the computation of a bank's Tier 1 capital. Certain of these intangible assets may, however, be recognized for regulatory capital purposes if explicitly approved by the Director of the Division of Supervision as part of the bank's regulatory capital on a specific case basis. These intangibles will be included in regulatory capital under the terms and conditions that are specifically approved by the FDIC.2

In certain instances banks may have investments in unconsolidated subsidiaries or joint ventures that have large volumes of intangible assets. In such instances the bank's

¹Although intangible assets in the form of mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships are generally recognized for gulatory capital purposes, the – deduction of part or all of the mortgage regulatory servicing assets, nonmortgage servicing assets and purchased credit card relationships may be required if the carrying amounts of these rights are excessive in relation to their market value or the level of the bank's capital accounts. In this regard, mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships will be recognized for regulatory capital purposes only to the extent the rights meet the conditions, limitations and restrictions described in §325.5(f).

²This specific approval must be received in accordance with §325.5(b). In evaluating whether other types of intangibles should be recognized for regulatory capital purposes, the FDIC will accord special attention to the general characteristics of the intangibles, including: (1) The separability of the intangible asset and the ability to sell it separate and apart from the bank or the bulk of the bank's assets, (2) the certainty that a readily identifiable stream of cash flows associated with the intangible asset can hold its value notwithstanding the future prospects of the bank, and (3) the existence of a market of sufficient depth to provide liquidity for the intangible asset. However, pursuant to section 18(n) of the Federal Deposit Insurance Act (12 U.S.C. 1828(n)), specific approval cannot be given for an unidentifiable intangible asset, such as goodwill, if acquired after April 12, 1989.

consolidated statements will reflect an investment in a tangible asset even though such investment will, in fact, be represented by a large volume of intangible assets. In any such situation where this is material. the bank's investment in the unconsolidated subsidiary will be divided into a tangible and an intangible portion based on the percentage of intangible assets to total assets in the subsidiary. The intangible portion of the investment will be treated as if it were an intangible asset on the bank's books in the calculation of Tier 1 capital. However, intangible assets in the form of mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships, including servicing intangibles held by mortgage banking subsidiaries, are subject to the specific criteria set forth in §325.5(f).

B. Perpetual Preferred Stock

Perpetual preferred stock is defined as preferred stock that does not have a maturity date, that cannot be redeemed at the option of the holder, and that has no other provisions that will require future redemption of the issue. Also, pursuant to section 18(i)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1828(i)(1)), a state nonmember bank cannot, without the prior consent of the FDIC, reduce the amount or retire any part of its perferred stock. (This prior consent is also required for the reduction or retirement of any part of a state nonmember bank's common stock or capital notes and debentures.)

Noncumulative perpetual preferred stock is generally included in Tier 1 capital. Nonetheless, it is possible for banks to issue preferred stock with a dividend rate which escalates to such a high rate that the terms become so onerous as to effectively force the bank to call the issue (for example, an issue with a low initial rate that is scheduled to escalate to much higher rates in subsequent periods). Preferred stock issues with such onerous terms have much the same characteristics as limited life preferred stock in that the bank would be effectively forced to redeem the issue to avoid performance of the onerous terms. Such instruments may be disallowed as Tier 1 capital and, for risk-based capital purposes, would be included in Tier 2 capital only to the extent that the instruments fall within the limitations applicable to intermediate-term preferred stock. Banks which are contemplating issues bearing terms which may be so characterized are encouraged to submit them to the appropriate FDIC regional office for review prior to issuance. Nothing herein shall prohibit banks from issuing floating rate preferred stock issues where the rate is constant in relation to some outside market or index rate. However, noncumulative floating rate instruments where the rate paid is based in some part on the current credit standing of

the bank, and all cumulative preferred stock instruments, are excluded from Tier 1 capital. These instruments are included in Tier 2 capital for risk-based capital purposes in accordance with the limitations set forth in appendix A to part 325.

The FDIC will also require that issues of perpetual preferred stock be consistent with safe and sound banking practices. Issues which would unduly enrich insiders or which contain dividend rates or other terms which are inconsistent with safe and sound banking practices will likely be the subject of appropriate supervisory response from the FDIC. Banks contemplating preferred stock issues which may pose safety and soundness concerns are encouraged to submit such issues to the appropriate FDIC regional office for review prior to sale. Pursuant to §325.5(e), capital instruments that contain or that are subject to any conditions, covenants, terms, restrictions or provisions that are inconsistent with safe and sound banking practices will not qualify as capital under part

C. Other Instruments or Transactions Which Fail to Provide Capital Support

Section 325.5(b) specifies that any capital component or balance sheet entry or account which has characteristics or terms that diminish its contribution to an insured depository institution's ability to absorb losses shall be deducted from capital. An example involves certain types of minority interests in consolidated subsidiaries. Minority interests in consolidated subsidiaries have been included in capital based on the fact that they provide capital support to the risk in the consolidated subsidiaries. Certain transactions have been structured where a bank forms a subsidiary by transferring essentially risk-free or low-risk assets to the subsidiary in exchange for common stock of the subsidiary. The subsidiary then sells preferred stock to third parties.

The preferred stock becomes a minority interest in a consolidated subsidiary but, in effect, represents an essentially risk-free or low-risk investment for the preferred stockholders. This type of minority interest fails to provide any meaningful capital support to the consolidated entity inasmuch as it has a preferred claim on the essentially risk-free or low-risk assets of the subsidiary. In addition, certain minority interests are not substantially equivalent to permanent equity in that the interests must be paid off on specified future dates, or at the option of the holders of the minority interests, or contain other provisions or features that limit the ability of the minority interests to effectively absorb losses. Capital instruments or transactions of this nature which fail to absorb losses or provide meaningful capital support will be deducted from Tier 1 capital.

D. Mandatory Convertible Debt

Mandatory convertible debt securities are subordinated debt instruments that require the issuer to convert such instruments into common or perpetual preferred stock by a date at or before the maturity of the debt instruments. The maturity of these instruments must be 12 years or less and the instruments must also meet the other criteria set forth in appendix A to part 325. Mandatory convertible debt is excluded from Tier 1 capital but, for risk-based capital purposes, is included in Tier 2 capital as a "hybrid capital instrument."

So-called "equity commitment notes," which merely require a bank to sell common or perpetual preferred stock during the life of the subordinated debt obligation, are specifically excluded from the definition of mandatory convertible debt securities and are only included in Tier 2 capital under the risk-based capital framework to the extent that they satisfy the requirements and limitations for "term subordinated debt" set forth in appendix A to part 325.

V. Analysis of Consolidated Companies

In determining a bank's compliance with its minimum capital requirements the FDIC will, with two exceptions, generally utilize the bank's consolidated statements as defined in the instructions for the preparation of Consolidated Reports of Condition and Income.

The first exception relates to securities subsidiaries of state nonmember banks which are subject to §337.4 of the FDIC's rules and regulations (12 CFR 337.4). Any subsidiary subject to this section must be a bona fide subsidiary which is adequately capitalized. In addition, §337.4(b)(3) requires that any insured state nonmember bank's investment in such a subsidiary shall not be counted towards the bank's capital. In those instances where the securities subsidiary is consolidated in the bank's Consolidated Report of Condition it will be necessary, for the purpose of calculating the bank's Tier 1 capital, to adjust the Consolidated Report of Condition in such a manner as to reflect the bank's investment in the securities subsidiary on the equity method. In this case, and in those cases where the securities subsidiary has not been consolidated, the investment in the subsidiary will then be deducted from the bank's capital and assets prior to calculation of the bank's Tier 1 capital ratio. (Where deemed appropriate, the FDIC may also consider deducting investments in other subsidiaries, either on a case-by-case basis or, as with securities subsidiaries, based on the general characteristics or functional nature of the subsidiaries.)

The second exception relates to the treatment of subsidiaries of insured banks that are domestic depository institutions such as

commercial banks, savings banks, or savings associations. These subsidiaries are not consolidated on a line-by-line basis with the insured bank parent in the bank parent's Consolidated Reports of Condition and Income. Rather, the instructions for these reports provide that bank investments in such depository institution subsidiaries are to be reported on an unconsolidated basis in accordance with the equity method. Since the FDIC believes that the minimum capital requirements should apply to a bank's depository activities in their entirety, regardless of the form that the organization's corporate structure takes, it will be necessary, for the purpose of calculating the bank's Tier 1 leverage and total risk-based capital ratios, to adjust a bank parent's Consolidated Report of Condition to consolidate its domestic depository institution subsidiaries on a line-by-line basis. The financial statements of the subsidiary that are used for this consolidation must be prepared in the same manner as the Consolidated Report of Condition.

The FDIC will, in determining the capital adequacy of a bank which is a member of a bank holding company or chain banking group, consider the degree of leverage and risks undertaken by the parent company or other affiliates. Where the level of risk in a holding company system is no more than normal and the consolidated company is adequately capitalized at all appropriate levels. the FDIC generally will not require additional capital in subsidiary banks under its supervision over and above that which would be required for the subsidiary bank on its own merit. In cases where a holding company or other affiliated banks (or other companies) evidence more than a normal degree of risk (either by virtue of the quality of their assets, the nature of the activities conducted, or other factors) or where the affiliated organizations are inadequately capitalized, the FDIC will consider the potential impact of the additional risk or excess leverage upon an individual bank to determine if such factors will likely result in excessive requirements for dividends, management fees, or other support to the holding company or affiliated organizations which would be detrimental to the bank. Where the excessive risk or leverage in such organizations is determined to be potentially detrimental to the bank's condition or its ability to maintain adequate capital, the FDIC may initiate appropriate supervisory action to limit the bank's ability to support its weaker affiliates and/or require higher than minimum capital ratios in the bank.

VI. APPLICABILITY OF PART 325 TO SAVINGS ASSOCIATIONS

Section 325.3(c) indicates that, where the FDIC is required to evaluate the adequacy of any depository institution's (including any

savings association's) capital structure in conjunction with an application filed by the institution, the FDIC will not approve the application if the depository institution does not meet the minimum leverage capital requirement set forth in §325.3(b).

Also, §325.4(b) states that, under certain conditions specified in section 8(t) of the Federal Deposit Insurance Act, the FDIC may take section 8(b)(1) and/or 8(c) enforcement action against a savings association that is deemed to be engaged in an unsafe or unsound practice on account of its inadequate capital structure. Section 325.4(c) further specifies that any insured depository institution with a Tier 1 leverage ratio (as defined in part 325) of less than 2 percent is deemed to be operating in an unsafe or unsound condition pursuant to section 8(a) of the Federal Deposit Insurance Act.

In addition, the Office of Thrift Supervision (OTS), as the primary federal regulator of savings associations, has established minimum core capital leverage, tangible capital and risk-based capital requirements for savings associations (12 CFR part 567). In this regard, certain differences exist between the methods used by the OTS to calculate a savings association's capital and the methods set forth by the FDIC in part 325. These differences include, among others, the core capital treatment for investments in subsidiaries and for certain intangible assets.

In determining whether a savings association's application should be approved pursuant to §325.3(c), or whether an unsafe or unsound practice or condition exists pursuant to §§ 325.4(b) and 325.4(c), the FDIC will consider the extent of the savings association's capital as determined in accordance with part 325. However, the FDIC will also consider the extent to which a savings association is in compliance with (a) the minimum capital requirements set forth by the OTS, (b) any related capital plans for meeting the minimum capital requirements approved by the OTS, and/or (c) any other criteria deemed by the FDIC as appropriate based on the association's specific circumstances.

[56 FR 10166, Mar. 11, 1991, as amended at 58 FR 6369, Jan. 28, 1993; 58 FR 8219, Feb. 12, 1993; 58 FR 60103, Nov. 15, 1993; 60 FR 39232, Aug. 1, 1995; 63 FR 42678, Aug. 10, 1998; 66 FR 59661, Nov. 29, 2001]

APPENDIX C TO PART 325—RISK-BASED CAPITAL FOR STATE NON-MEMBER BANKS: MARKET RISK

Section 1. Purpose, Applicability, Scope, and Effective Date

(a) *Purpose*. The purpose of this appendix is to ensure that banks with significant exposure to market risk maintain adequate cap-

ital to support that exposure. This appendix supplements and adjusts the risk-based capital ratio calculations under appendix A of this part with respect to those banks.

- (b) Applicability. (1) This appendix applies to any insured state nonmember bank whose trading activity ² (on a worldwide consolidated basis) equals:
- (i) 10 percent or more of total assets; 3 or
- (ii) \$1 billion or more.
- (2) The FDIC may additionally apply this appendix to any insured state nonmember bank if the FDIC deems it necessary or appropriate for safe and sound banking practices.
- (3) The FDIC may exclude an insured state nonmember bank otherwise meeting the criteria of paragraph (b)(1) of this section from coverage under this appendix if it determines the bank meets such criteria as a consequence of accounting, operational, or similar considerations, and the FDIC deems it consistent with safe and sound banking practices
- (c) *Scope*. The capital requirements of this appendix support market risk associated with a bank's covered positions.
- (d) Effective date. This appendix is effective as of January 1, 1997. Compliance is not mandatory until January 1, 1998. Subject to supervisory approval, a bank may opt to comply with this appendix as early as January 1, 1997 4

Section 2. Definitions

For purposes of this appendix, the following definitions apply:

(a) Covered positions means all positions in a bank's trading account, and all foreign exchange⁵ and commodity positions, whether

²Trading activity means the gross sum of trading assets and liabilities as reported in the bank's most recent quarterly Consolidated Report of Condition and Income (Call Report).

³Total assets means quarter-end total assets as reported in the bank's most recent Call Report.

⁴A bank that voluntarily complies with the final rule prior to January 1, 1998, must comply with all of its provisions.

⁵Subject to FDIC review, a bank may exclude structural positions in foreign currencies from its covered positions.

¹This appendix is based on a framework developed jointly by supervisory authorities from the countries represented on the Basle Committee on Banking Supervision and endorsed by the Group of Ten Central Bank Governors. The framework is described in a Basle Committee paper entitled "Amendment to the Capital Accord to Incorporate Market Risks," January 1996. Also see modifications issued in September 1997.

or not in the trading account.⁶ Positions include on-balance-sheet assets and liabilities and off-balance-sheet items. Securities subject to repurchase and lending agreements are included as if they are still owned by the lender.

- (b) Market risk means the risk of loss resulting from movements in market prices. Market risk consists of general market risk and specific risk components.
- (1) General market risk means changes in the market value of covered positions resulting from broad market movements, such as changes in the general level of interest rates, equity prices, foreign exchange rates, or commodity prices.
- (2) Specific risk means changes in the market value of specific positions due to factors other than broad market movements and includes event and default risk as well as idiosyncratic variations.
- (c) Tier 1 and Tier 2 capital are defined in appendix A of this part.
- (d) Tier 3 capital is subordinated debt that is unsecured; is fully paid up; has an original maturity of at least two years; is not redeemable before maturity without prior approval by the FDIC; includes a lock-in clause precluding payment of either interest or principal (even at maturity) if the payment would cause the issuing bank's risk-based capital ratio to fall or remain below the minimum required under appendix A of this part; and does not contain and is not covered by any covenants, terms, or restrictions that are inconsistent with safe and sound banking practices.
- (e) Value-at-risk (VAR) means the estimate of the maximum amount that the value of covered positions could decline during a fixed holding period within a stated confidence level, measured in accordance with section 4 of this appendix.

Section 3. Adjustments to the Risk-Based Capital Ratio Calculations.

- (a) Risk-based capital ratio denominator. A bank subject to this appendix shall calculate its risk-based capital ratio denominator as follows:
- (1) Adjusted risk-weighted assets. Calculate adjusted risk-weighted assets, which equals risk-weighted assets (as determined in accordance with appendix A of this part), excluding the risk-weighted amounts of all covered positions (except foreign exchange positions outside the trading account and over-the-counter derivative positions) and

receivables arising from the posting of cash collateral that is associated with securities borrowing transactions to the extent the receivables are collateralized by the market value of the borrowed securities, provided that the following conditions are met:

- (i) The transaction is based on securities includable in the trading book that are liquid and readily marketable.
- (ii) The transaction is marked to market daily.
- (iii) The transaction is subject to daily margin maintenance requirements,
- (iv) The transaction is a securities contract for the purposes of section 555 of the Bankruptcy Code (11 U.S.C. 555), a qualified financial contract for the purposes of section 11(e)(8) of the Federal Deposit Insurance Act (12 U.S.C. 1821(e)(8)), or a netting contract between or among financial institutions for the purposes of sections 401–407 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (12 U.S.C. 4401–4407), or the Board's Regulation EE (12 CFR Part 231).
- (2) Measure for market risk. Calculate the measure for market risk, which equals the sum of the VAR-based capital charge, the specific risk add-on (if any), and the capital charge for de minimis exposures (if any).
- (i) VAR-based capital charge. The VAR-based capital charge equals the higher of:
- (A) The previous day's VAR measure; or
- (B) The average of the daily VAR measures for each of the preceding 60 business days multiplied by three, except as provided in section 4(e) of this appendix;
- (ii) Specific risk add-on. The specific risk add-on is calculated in accordance with section 5 of this appendix; and
- (iii) Capital charge for de minimis exposure. The capital charge for de minimis exposure is calculated in accordance with section 4(a) of this appendix.
- (3) Market risk equivalent assets. Calculate market risk equivalent assets by multiplying the measure for market risk (as calculated in paragraph (a)(2) of this section) by 12.5
- (4) Denominator calculation. Add market risk equivalent assets (as calculated in paragraph (a)(3) of this section) to adjusted risk-weighted assets (as calculated in paragraph (a)(1) of this section). The resulting sum is the bank's risk-based capital ratio denominator.
- (b) Risk-based capital ratio numerator. A bank subject to this appendix shall calculate its risk-based capital ratio numerator by allocating capital as follows:
- (1) Credit risk allocation. Allocate Tier 1 and Tier 2 capital equal to 8.0 percent of adjusted

 $^{^6\}mathrm{The}$ term trading account is defined in the instructions to the Call Report.

⁷Foreign exchange positions outside the trading account and all over-the-counter derivative positions, whether or not in the trading account, must be included in the ad-

justed risk weighted assets as determined in appendix A of this part.

risk-weighted assets (as calculated in paragraph (a)(1) of this section).8

- (2) Market risk allocation. Allocate Tier 1, Tier 2, and Tier 3 capital equal to the measure for market risk as calculated in paragraph (a)(2) of this section. The sum of Tier 2 and Tier 3 capital allocated for market risk must not exceed 250 percent of Tier 1 capital allocated for market risk. (This requirement means that Tier 1 capital allocated in this paragraph (b)(2) must equal at least 28.6 percent of the measure for market risk.)
- (3) Restrictions. (i) The sum of Tier 2 capital (both allocated and excess) and Tier 3 capital (allocated in paragraph (b)(2) of this section) may not exceed 100 percent of Tier 1 capital (both allocated and excess).9
- (ii) Term subordinated debt (and intermediate-term preferred stock and related surplus) included in Tier 2 capital (both allocated and excess) may not exceed 50 percent of Tier 1 capital (both allocated and excess).
- (4) Numerator calculation. Add Tier 1 capital (both allocated and excess), Tier 2 capital (both allocated and excess), and Tier 3 capital (allocated under paragraph (b)(2) of this section). The resulting sum is the bank's risk-based capital ratio numerator.

Section 4. Internal Models

- (a) General. For risk-based capital purposes, a bank subject to this appendix must use its internal model to measure its daily VAR, in accordance with the requirements of this section. ¹⁰ The FDIC may permit a bank to use alternative techniques to measure the market risk of de minimis exposures so long as the techniques adequately measure associated market risk.
- (b) $Qualitative\ requirements.$ A bank subject to this appendix must have a risk manage-

⁸A bank may not allocate Tier 3 capital to support credit risk (as calculated under appendix A of this part).

⁹Excess Tier 1 capital means Tier 1 capital that has not been allocated in paragraphs (b)(1) and (b)(2) of this section. Excess Tier 2 capital means Tier 2 capital that has not been allocated in paragraph (b)(1) and (b)(2) of this section, subject to the restrictions in paragraph (b)(3) of this section.

¹⁰A bank's internal model may use any generally accepted measurement techniques, such as variance-covariance models, historical simulations, or Monte Carlo simulations. However, the level of sophistication and accuracy of a bank's internal model must be commensurate with the nature and size of its covered positions. A bank that modifies its existing modeling procedures to comply with the requirements of this appendix for risk-based capital purposes should, nonetheless, continue to use the internal model it considers most appropriate in evaluating risks for other purposes.

ment system that meets the following minimum qualitative requirements:

- (1) The bank must have a risk control unit that reports directly to senior management and is independent from business trading units.
- (2) The bank's internal risk measurement model must be integrated into the daily management process.
- (3) The bank's policies and procedures must identify, and the bank must conduct, appropriate stress tests and backtests. ¹¹ The bank's policies and procedures must identify the procedures to follow in response to the results of such tests.
- (4) The bank must conduct independent reviews of its risk measurement and risk management systems at least annually.
- (c) Market risk factors. The bank's internal model must use risk factors sufficient to measure the market risk inherent in all covered positions. The risk factors must address interest rate risk, ¹² equity price risk, foreign exchange rate risk, and commodity price risk.
- (d) Quantitative requirements. For regulatory capital purposes, VAR measures must meet the following quantitative requirements:
- (1) The VAR measures must be calculated on a daily basis using a 99 percent, one-tailed confidence level with a price shock equivalent to a ten-business day movement in rates and prices. In order to calculate VAR measures based on a ten-day price shock, the bank may either calculate ten-day figures directly or convert VAR figures based on holding periods other than ten days to the equivalent of a ten-day holding period (for instance, by multiplying a one-day VAR measure by the square root of ten).
- (2) The VAR measures must be based on an historical observation period (or effective observation period for a bank using a weighting scheme or other similar method) of at least one year. The bank must update data sets at least once every three months or more frequently as market conditions warrant.

¹¹Stress tests provide information about the impact of adverse market events on a bank's covered positions. Backtests provide information about the accuracy of an internal model by comparing a bank's daily VAR measures to its corresponding daily trading profits and losses.

¹² For material exposures in the major currencies and markets, modeling techniques must capture spread risk and must incorporate enough segments of the yield curve—at least six—to capture differences in volatility and less than perfect correlation of rates along the yield curve.

- (3) The VAR measures must include the risks arising from the non-linear price characteristics of options positions and the sensitivity of the market value of the positions to changes in the volatility of the underlying rates or prices. A bank with a large or complex options portfolio must measure the volatility of options positions by different maturities.
- (4) The VAR measures may incorporate empirical correlations within and across risk categories, provided that the bank's process for measuring correlations is sound. In the event that the VAR measures do not incorporate empirical correlations across risk categories, then the bank must add the separate VAR measures for the four major risk categories to determine its aggregate VAR measure.
- (e) Backtesting. (1) Beginning one year after a bank starts to comply with this appendix, a bank must conduct backtesting by comparing each of its most recent 250 business days' actual net trading profit or loss 13 with the corresponding daily VAR measures generated for internal risk measurement purposes and calibrated to a one-day holding period and a 99 percent, one-tailed confidence level.
- (2) Once each quarter, the bank must identify the number of exceptions, that is, the number of business days for which the magnitude of the actual daily net trading loss, if any, exceeds the corresponding daily VAR measure
- (3) A bank must use the multiplication factor indicated in Table 1 of this appendix in determining its capital charge for market risk under section 3(a)(2)(i)(B) of this appendix until it obtains the next quarter's backtesting results, unless the FDIC determines that a different adjustment or other action is appropriate.

TABLE 1—MULTIPLICATION FACTOR BASED ON RESULTS OF BACKTESTING

Number of exceptions	Multiplica- tion factor
4 or fewer	3.00
5	3.40
6	3.50
7	3.65
8	3.75
9	3.85
10 or more	4.00

Section 5. Specific Risk

(a) Modeled specific risk. A bank may use its internal model to measure specific risk. If

the bank has demonstrated to the FDIC that its internal model measures the specific risk, including event and default risk as well as idiosyncratic variation, of covered debt and equity positions and includes the specific risk measure in the VAR-based capital charge in section 3(a)(2)(i) of this appendix. then the bank has no specific risk add-on for purposes of section 3(a)(2)(ii) of this appendix. The model should explain the historical price variation in the trading portfolio and capture concentration, both magnitude and changes in composition. The model should also be robust to an adverse environment and have been validated through backtesting which assesses whether specific risk is being accurately captured.

- (b) Add-on charge for modeled specific risk. A bank that incorporates specific risk in its internal model but fails to demonstrate to the FDIC that its internal model adequately measures all aspects of specific risk for covered debt and equity positions, including event and default risk, as provided by section 5(a) of this appendix, must calculate the bank's specific risk add-on for purposes of section 3(a)(2)(ii) of this appendix as follows:
- (1) If the model is capable of valid separation of the VAR measure into a specific risk portion and a general market risk portion, then the specific risk add-on is equal to the previous day's specific risk portion.
- (2) If the model does not separate the VAR measure into a specific risk portion and a general market risk portion, then the specific risk add-on is the sum of the previous day's VAR measures for subportfolios of covered debt and equity positions.
- (c) Add-on charge if specific risk is not modeled. If a bank does not model specific risk in accordance with paragraph (a) or (b) of this section, the bank's specific risk add-on charge for purposes of section 3(a)(2)(ii) of this appendix equals the sum of the components for covered debt and equity positions. If a bank models, in accordance with paragraph (a) or (b) of this section, the specific risk of covered debt positions but not covered equity positions (or vice versa), then the bank's specific risk add-on charge for the positions not modeled is the component for covered debt or equity positions as appropriate:
- (1) Covered debt positions. (i) For purposes of this section 5, covered debt positions means fixed-rate or floating-rate debt instruments located in the trading account and instruments located in the trading account with values that react primarily to changes in interest rates, including certain non-convertible preferred stock, convertible bonds, and instruments subject to repurchase and lending agreements. Also included are derivatives (including written and purchased options) for which the underlying instrument is a covered debt instrument that is subject to a non-zero specific risk capital charge.

¹³ Actual net trading profits and losses typically include such things as realized and unrealized gains and losses on portfolio positions as well as fee income and commissions associated with trading activities.

- (A) For covered debt positions that are derivatives, a bank must risk-weight (as described in paragraph (c)(1)(iii) of this section) the market value of the effective notional amount of the underlying debt instrument or index portfolio. Swaps must be included as the notional position in the underlying debt instrument or index portfolio, with a receiving side treated as a long position and a paying side treated as a short position; and
- (B) For covered debt positions that are options, whether long or short, a bank must risk-weight (as described in paragraph (c)(1)(iii) of this section) the market value of the effective notional amount of the underlying debt instrument or index multiplied by the option's delta.
- (ii) A bank may net long and short covered debt positions (including derivatives) in identical debt issues or indices.
- (iii) A bank must multiply the absolute value of the current market value of each net long or short covered debt position by the appropriate specific risk weighting factor indicated in Table 2 of this appendix. The specific risk capital charge component for covered debt positions is the sum of the weighted values.

TABLE 2—SPECIFIC RISK WEIGHTING FACTORS
FOR COVERED DEBT POSITIONS

Category	Remaining matu- rity (contractual)	Weighting factor (in percent)
Government	N/A	0.00 0.25 1.00
Other	Over 24 months N/A	1.60 8.00

- (A) The government category includes all debt instruments of central governments of OECD-based countries ¹⁴ including bonds, Treasury bills, and other short-term instruments, as well as local currency instruments of non-OECD central governments to the extent the bank has liabilities booked in that currency.
- (B) The qualifying category includes debt instruments of U.S. government-sponsored agencies, general obligation debt instruments issued by states and other political subdivisions of OECD-based countries, multilateral development banks, and debt instruments issued by U.S. depository institutions or OECD-banks that do not qualify as capital of the issuing institution. This category

- also includes other debt instruments, including corporate debt and revenue instruments issued by states and other political subdivisions of OECD countries, that are:
- (1) Rated investment-grade by at least two nationally recognized credit rating services;
- (2) Rated investment-grade by one nationally recognized credit rating agency and not rated less than investment-grade by any other credit rating agency; or
- (3) Unrated, but deemed to be of comparable investment quality by the reporting bank and the issuer has instruments listed on a recognized stock exchange, subject to review by the FDIC.
- (C) The *other* category includes debt instruments that are not included in the government or qualifying categories.
- (2) Covered equity positions. (i) For purposes of this section 5, covered equity positions means equity instruments located in the trading account and instruments located in the trading account with values that react primarily to changes in equity prices, including voting or non-voting common stock, certain convertible bonds, and commitments to buy or sell equity instruments. Also included are derivatives (including written and purchased options) for which the underlying is a covered equity position.
- (A) For covered equity positions that are derivatives, a bank must risk weight (as described in paragraph (c)(2)(iii) of this section) the market value of the effective notional amount of the underlying equity instrument or equity portfolio. Swaps must be included as the notional position in the underlying equity instrument or index portfolio, with a receiving side treated as a long position and a paying side treated as a short position; and
- (B) For covered equity positions that are options, whether long or short, a bank must risk weight (as described in paragraph (c)(2)(iii) of this section) the market value of the effective notional amount of the underlying equity instrument or index multiplied by the option's delta.
- (ii) A bank may net long and short covered equity positions (including derivatives) in identical equity issues or equity indices in the same market. 16
- (iii)(A) A bank must multiply the absolute value of the current market value of each net long or short covered equity position by a risk weighting factor of 8.0 percent, or by 4.0 percent if the equity is held in a portfolio

¹⁴Organization for Economic Cooperation and Development (OECD)-based countries is defined in appendix A of this part.

¹⁵U.S. government-sponsored agencies, multilateral development banks, and OECD banks are defined in appendix A of this part.

¹⁶ A bank may also net positions in depository receipts against an opposite position in the underlying equity or identical equity in different markets, provided that the bank includes the costs of conversion.

that is both liquid and well-diversified.¹⁷ For covered equity positions that are index contracts comprising a well-diversified portfolio of equity instruments, the net long or short position is multiplied by a risk weighting factor of 2.0 percent.

(B) For covered equity positions from the following futures-related arbitrage strategies, a bank may apply a 2.0 percent risk weighting factor to one side (long or short) of each position with the opposite side exempt from charge, subject to review by the FDIC:

- (1) Long and short positions in exactly the same index at different dates or in different market centers; or
- (2) Long and short positions in index contracts at the same date in different but similar indices.
- (C) For futures contracts on broadly-based indices that are matched by offsetting positions in a basket of stocks comprising the index, a bank may apply a 2.0 percent risk weighting factor to the futures and stock basket positions (long and short), provided that such trades are deliberately entered into and separately controlled, and that the basket of stocks comprises at least 90 percent of the capitalization of the index.
- (iv) The specific risk capital charge component for covered equity positions is the sum of the weighted values.

[61 FR 47376, Sept. 6, 1996, as amended at 62 FR 68068, Dec. 30, 1997; 64 FR 19038, Apr. 19, 1999; 65 FR 75859, Dec. 5, 2000]

PART 326—MINIMUM SECURITY DE-VICES AND PROCEDURES AND BANK SECRECY ACT 1 COMPLI-ANCE

Subpart A—Minimum Security Procedures

Sec.

326.0 Authority, purpose, and scope.

¹⁷A portfolio is liquid and well-diversified if: (1) it is characterized by a limited sensitivity to price changes of any single equity issue or closely related group of equity issues held in the portfolio; (2) the volatility of the portfolio's value is not dominated by the volatility of any individual equity issue or by equity issues from any single industry or economic sector; (3) it contains a large number of individual equity positions, with no single position representing a substantial portion of the portfolio's total market value; and (4) it consists mainly of issues traded on organized exchanges or in well-established over-the-counter markets.

¹In its original form, subchapter II of chapter 53 of title 31 U.S.C., was part of Pub. L. 91–508 which requires recordkeeping for and reporting of currency transactions by banks

- 326.1 Definitions.
- 326.2 Designation of security officer.
- 326.3 Security program.
- 326.4 Reports.

Subpart B—Procedures for Monitoring Bank Secrecy Act Complianace

326.8 Bank Secrecy Act compliance.

AUTHORITY: 12 U.S.C. 1813, 1815, 1817, 1818, 1819 [Tenth], 1881-1883; 31 U.S.C. 5311-5324.

Subpart A—Minimum Security Procedures

SOURCE: 56 FR 13581, Apr. 3, 1991, unless otherwise noted

§ 326.0 Authority, purpose, and scope.

- (a) This part is issued by the Federal Deposit Insurance Corporation ("FDIC") pursuant to section 3 of the Bank Protection Act of 1968 (12 U.S.C. 1882). It applies to insured state banks that are not members of the Federal Reserve System. It requires each bank to adopt appropriate security procedures to discourage robberies, burglaries, and larcenies and to assist in identifying and apprehending persons who commit such acts.
- (b) It is the responsibility of the bank's board of directors to comply with this part and ensure that a written security program for the bank's main office and branches is developed and implemented.

(Approved by the Office of Management and Budget under control number 3064–0095)

§ 326.1 Definitions.

For the purposes of this part—

(a) The term insured nonmember bank means any bank, including a foreign bank having a branch the deposits of which are insured in accordance with the provisions of the Federal Deposit Insurance Act, which is not a member of the Federal Reserve System. The term does not include any institution chartered or licensed by the Comptroller of the Currency, any District bank, or any savings association.

(b) The term banking office includes any branch of an insured nonmember bank, and, in the case of an insured

and others and is commonly known as the Bank Secrecy Act.